June 13, 2023

VIA ELECTRONIC DELIVERY

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

RE: **Proposed Rule: Regulation Systems Compliance and Integrity, Release No. 34-97143, File No. S7-07-23 (Mar. 15, 2023)**

Dear Ms. Countryman:

Virtu Financial, Inc. ("Virtu")[1] respectfully submits this letter in response to the above-referenced proposed rule issued by the Securities and Exchange Commission (the "SEC" or "Commission") on March 15, 2023, that would substantially amend Regulation Systems Compliance and Integrity ("Regulation SCI"), including by expanding the scope of "SCI entities" to include registered broker-dealers that exceed either a total assets threshold or a transaction activity threshold in certain securities (the "Proposal").[2]

Virtu has long been a vocal proponent of smart, data-driven regulation that supports the goals of enhancing transparency, fostering robust competition among market participants, and ensuring the high quality of the retail investor experience. Unfortunately, the Proposal fails to achieve these objectives. Regulation SCI as originally adopted has now been in effect for close to eight years. There is scant evidence that this regulation has achieved its stated objectives although there is likely substantial evidence of its costs and burdens. Instead of assessing whether Regulation SCI has materially achieved the goals sought when it was adopted, the Commission now seeks to expand its reach with the current Proposal by extending the rule to broker-dealers that compete to provide services in the market ecosystem but are not the systematically important entities that Regulation SCI was designed to address. Unlike systemically important entities, as defined by Regulation SCI such as exchanges, SIPs, and registered clearing agencies, broker-

[1] Virtu is a leading financial firm that leverages cutting edge technology to deliver liquidity to the global markets and innovative, transparent trading solutions to its clients. Virtu operates as a market maker across numerous exchanges in the U.S. and is a member of all U.S. registered stock exchanges. Virtu's market structure expertise, broad diversification, and execution technology enables it to provide competitive bids and offers in over 25,000 securities, at over 235 venues, in 36 countries worldwide. As such, Virtu broadly supports innovation and enhancements to transparency and fairness which enhance liquidity to the benefit of all marketplace participants.

[2] U.S. Securities and Exchange Commission, Proposed Rule, *Regulation Systems Compliance and* Integrity, Release No. 34-97143; File No. S7-07-23 (Mar. 15, 2023), available at https://www.sec.gov/rules/proposed/2023/34-97143.pdf.

dealers are competitive substitutes for each other and therefore are not critical components of the market infrastructure that should be subject to the requirements of Regulation SCI.

Equally concerning is the Commission's grossly underestimated projection of costs that extending Regulation SCI to broker-dealers would entail – we believe the actual implementation costs could easily reach multiples of the Commission's estimates. Just like the Commission's misguided December 2022 equity market structure proposals that would jeopardize billions of dollars in benefits to retail investors, the Proposal represents yet another flank of an all-out assault by the current Commission on wholesalers like Virtu because of the Chair's clear preference for reduced market center competition and a desire to concentrate market activity on exchanges.

I. Broker-Dealers Are Competitive Substitutes – Not Critical Components of the Markets Infrastructure That Regulation SCI Was Designed to Address

a. The Commission's Objective in Adopting Regulation SCI was to Ensure the Integrity of the Core Technological Systems of the Markets Necessary to Support Exchange Processes, Market Data Distribution, and Clearing and Settlement Functions

When the Commission first adopted Regulation SCI in November 2014, the impetus for the rule was to address system integrity at entities providing ***critical infrastructure*** that the markets rely on to carry out trading activities (e.g., exchanges), entities that disseminate market data (e.g., FINRA and the SIPs), and those that perform clearance and settlement (the registered clearing corporations that provide critical central counter-party risk mitigation, centralized clearance, and centralized settlement services to the industry as a whole). As stated by Chair Mary Jo White in a speech in January 2017, "[t]he Commission also took significant action to enhance the operational integrity of the market systems on which investors depend every day. It adopted Regulation Systems Compliance and Integrity, or SCI, which ***requires key market participants*** – including the exchanges, high-volume alternative trading systems, and clearing agencies – to have comprehensive policies and procedures in place to ensure the capacity, integrity, resiliency, availability, and security of key automated systems."[3]

The technological systems originally covered by the 2014 Regulation SCI rule were limited to critical systems that provided the infrastructure necessary to support exchange auction processes, market data distribution by the SIPs, and critical clearing and settlement systems of the SRO clearing agencies. Broker-dealer systems decidedly were not a motivating concern for the Commission in adopting the 2014 rule. Indeed, then-Chair White was careful to note at the Open Meeting where the rule was adopted that, should additional steps be needed in the future to address regulatory gaps, the Commission should not merely expand the categories of market participants covered by the rule to include broker-dealers. Rather, she cautioned that the regulations would need to be adapted to different types of market participants and instructed her staff to consider

[3] SEC Chair Mary Jo White, *The SEC in 2017 and the Path Ahead* (Jan. 23, 2017), available at https://wwws.law.northwestern.edu/academics/continuing-legal-education/sri//documents/sri-remarks-mary-jo-white-1-23-2017.pdf (emphasis added).

"whether an *SCI-like* framework should be developed for other key market participants, such as broker-dealers and transfer agents."[4]

In the Proposal, the Commission fails to point to any data or evidence indicating that there has been a change in circumstances warranting consideration of "adapting" Regulation SCI to cover broker-dealers. Nowhere in the Proposal is there a reference to a broker-dealer technological systems issue that led to a systemic disruption in the marketplace, nor does the Proposal include any analysis of the potential that a systems integrity event at a broker-dealer could present risk of systemic harm to the markets or investors. The Proposal also neglects to acknowledge that the intense competition that exists among broker-dealers already incentivizes them to continuously invest in and enhance their systems' reliability and product offerings.

b. The Proposal Fails to Recognize That Broker-Dealers Are Not Critical Market Infrastructure – They Are Competitive Substitutes for Each Other

The Proposal also misses the mark in that it fails to recognize broker-dealers for what they are – fungible substitutes for each other in a highly competitive marketplace, not critical components of market infrastructure. That is, broker-dealers try to earn business by investing in their offerings to provide desirable products and services to their clients. The Proposal would sweep broker-dealers into the scope of Regulation SCI based on arbitrary trading and asset thresholds that bear no relation to the risks that the Commission is purportedly trying to address. The mere fact that a broker-dealer holds a certain level of assets or engages in a certain level of transaction activity does not mean that the broker-dealer is engaged in a critically important function within the market or that a systems outage at the broker-dealer would pose a substantial risk to the maintenance of fair and orderly markets.

Unlike SROs, broker-dealers are easily substitutable within the market with most participants employing multiple broker-dealers. In today's marketplace, investors can switch broker-dealers almost instantaneously with the click of a mouse, and most investors already have and use multiple broker-dealers. Broker-dealers have the flexibility to enter or exit the market based on current market conditions, and if a broker-dealer acting as a trading center has to (or chooses) to exit the market for any reason, order flow can be routed to other broker-dealers that perform similar functions. Broker-dealers play a fungible role in the marketplace and no single broker-dealer is the sole source of a critical market function as identified by Regulation SCI. The Proposal declines to recognize this important dynamic and instead attempts to apply a regulatory construct designed for SROs - that provide critical market functions - to broker-dealers, without any tailoring to account for the very stark differences in the disparate roles these entities play.

In other words, the Commission has failed to establish a justifiable basis that warrants expanding Regulation SCI to broker-dealers – and in so doing has failed to identify a market failure that needs to be addressed and thus the Proposal runs contrary to the requirements under the APA.

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[4] SEC Chair Mary Jo White, Statement at Open Meeting on Regulation SCI, (Nov. 19, 2014), available at https://www.sec.gov/news/statement/spch112014mjw.

II. The Proposal is Redundant of Other Regulations Governing Broker-Dealers and Would Foist Unnecessary Costs and Burdens on Them

a. Broker-Dealers Already Are Subject to Myriad SEC and FINRA Rules That Address Systems Integrity

Also absent from the Proposal is any discussion of why the current regulatory requirements for broker-dealers are inadequate to protect against the systems integrity issues the Proposal aims to address. Specifically, broker-dealers are subject to a host of SEC and FINRA rules mandating policies and procedures, systems monitoring and testing, and systems controls to prevent outages. Most notably, broker-dealers are subject to the Exchange Act Rule 15c3-5,[5] known as the "Market Access Rule", which imposes a strict framework of regulatory obligations on broker-dealers to ensure the integrity of their systems. As Commissioner Uyeda noted in his dissent:

> "There are similar concerns with applying Regulation SCI to large broker-dealers given the existing regulatory framework from both the Commission and FINRA. For example, these entities are subject to the Commission's Market Access Rule, under which they 'must establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity.' The Market Access Rule requires "that the financial risk management controls and supervisory procedures must be reasonably designed to limit systematically the financial exposure of the broker or dealer that could arise from market access … [and] requires that regulatory risk management controls and supervisory procedures be reasonably designed to ensure compliance with all regulatory requirements.' Broker-dealers are further subject to other rules with respect to financial responsibility, record-keeping rules, business continuity and disaster recovery plans, and supervisory obligations for outsourcing."[6]

The Commission adopted the Market Access Rule in 2010 in order to "ensure that broker-dealers appropriately control the risks associated with market access, so as not to jeopardize their own financial condition, that of other market participants, the integrity of trading on the securities markets, and the stability of the financial system."[7] Both the SEC and FINRA regularly examine broker-dealers for compliance with the Market Access Rule and have the authority to bring enforcement actions for violations. The Proposal neglects to explain why the Market Access Rule is inadequate to achieve the systems integrity goals that the Commission is aiming to advance. Broker-dealers already invest millions of dollars in technology and compliance resources to comply with the Market Access Rule.

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[5] 17 CFR § 240.15c3-5.

[6] Commissioner Mark Uyeda, *Statement on the Proposed Amendments to Regulation Systems Compliance and Integrity* (Mar. 15, 2023), *available at* https://www.sec.gov/news/statement/uyeda-statement-regulation-sci-031523.

[7] Final Rule: *Risk Management Controls for Brokers or Dealers with Market Access*, Release No. 34-63241, File No. S7-03-10 (Nov. 3, 2010), *available at* https://www.sec.gov/rules/final/2010/34-63241.pdf.

Broker-dealers are also subject to an overlapping framework of FINRA rules that address systems integrity. For example, FINRA Rule 4370(c) requires that FINRA members' business continuity plans address all mission critical systems (defined to include any system necessary to ensure prompt and accurate processing of securities transactions) and how the member will assure customers' prompt access to their funds and securities. Broker-dealers are also subject to FINRA's 2015 Report on Cybersecurity Practices, which strongly encourages broker-dealers to consider industry frameworks and standards as reference points for cybersecurity practices, including NIST Frameworks and ISO 27001 and 27002. FINRA Rule 3120(a) requires members to create an annual report detailing the member's system of supervisory controls, the summary of test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results. And under FINRA Rule 3130, members must certify annually that they have in place processes to establish, maintain, review, test and modify policies and procedures reasonably designed to achieve compliance with FINRA rules, MSRB rules and federal securities laws and regulations.

The Proposal fails to adequately address why these existing SEC and FINRA rules are insufficient to ensure that broker-dealers appropriately maintain systems integrity and therefore fails to justify why broker-dealers should be encompassed within the scope of Regulation SCI.

b. The Proposal Is Needlessly Complex and Would Unnecessarily Impose Unjustified Burdens and Costs on Broker-Dealers

Broker-dealers are not a singular entity type but rather are a diverse group of businesses competing to provide an array of products and services to the market. Some broker-dealers procure their systems from third-party providers, others employ teams of software developers and network engineers to create bespoke applications and processes through which they provide their unique mix of products and services, and others employ a mix of buy and build. The software developers that write the code for these systems employ modern development practices featuring continuous development and continuous integration, which allows for systems to be continually upgraded, tested, and evolved.

In describing broker-dealer systems, there is no single taxonomy into which systems may be characterized. One might broadly characterize them as front office systems which support the receipt of orders and market data from the SIPS, the execution of orders, or routing of orders for execution including to the SRO exchanges; middle office systems which perform a variety of post-trade functions supporting the submission of transactions to the back office; and back-office systems which interface with the facilities of the SRO registered clearing agencies to submit transactions for clearance and settlement. However, broker-dealer system functions may be architected in ways that blur these distinctions, and as technology advances, they evolve over time to support the competitive needs of the broker-dealer.

Unlike (i) the exchanges that, as trading centers, enjoy trade through-protections that prevent other market participants from trading through their protected prices, (ii) the SIPS, which

serve to consolidate and disseminate the best bids and offers of every trading center and report the last sale data of every transaction across all trading centers; and (iii) the registered clearing agencies, which provide critical central counter-party netting, risk mitigation, and settlement services, broker-dealer systems do not perform any of these critical market-wide functions. Broker-dealer systems are unique, bespoke systems designed to support the needs of the segments of the market which the broker-dealer has chosen to service for its unique mix of clients. Broker-dealers compete to provide these services and exist in an ecosystem of multiple competing parties providing duplicate and overlapping services. Return on capital is a critical driver for a broker-dealer when deciding which services to provide and where it wants to compete. If the operating expense does not justify the return, then fewer competitors may exist to provide a particular service or to service a particular segment of the market.

Regulation SCI in its current formulation and its proposed reformulation necessarily increases the costs of entities that are deemed to be SCI entities, which the SEC readily acknowledges. However, we believe the SEC has underestimated these costs by one or more orders of magnitude. To illustrate the problem, we start with the arbitrary definitions of what are SCI systems, critical SCI systems, and indirect SCI systems. If adopted, the Proposal would force SCI entities to engage in an unnatural exercise of characterizing their systems based upon the bureaucratic taxonomy imposed by the Proposal, which the Commission suggests is "[a] foundational and essential step for an SCI entity to be able to meet its obligations under Regulation SCI is to be able to identify clearly the systems that are subject to obligations under Regulation SCI."[8]

The Commission defines "SCI systems" as meaning "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."[9] "Indirect SCI systems" come into play with respect to security standards and systems intrusions and include "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."[10] Any system that is not an indirect SCI system falls into the bucket of a critical SCI system. Whether a system directly or indirectly supports trading according to the SEC's definition may in some instances be obvious, but in just as many instances it is far from obvious. Yet broker-dealers will be forced to spend countless hours engaged in a taxonomy exercise with specious benefits.

The Proposal would require SCI entities to create voluminous policies and procedures intended broadly to apply to technology that supports trading, clearance and settlement, order routing, market data, and market surveillance. These procedures would require SCI entities to pinpoint precisely when a given system "becomes" an SCI system (or an indirect SCI system), as well as the point at which it is officially "no longer" an SCI system (or an indirect SCI system). The procedures would be required to address, among other things, the overall capacity, integrity,

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[8] Proposal at 103.
[9] Proposal at 102.
[10] Proposal at 15.

resilience, availability, and security of a firm's SCI systems. SCI broker-dealers would be required to create programs, including but not limited to:

- Programs designed to inventory and classify its systems;
- A program for the lifecycle management program for SCI systems and indirect SCI systems;
- A program to identify SCI personnel;
- A program to manage and oversee third-party providers, including cloud service providers, that provide or support SCI or indirect SCI systems;
- BC/DR plans and programs that address the unavailability of a broker-dealer's own SCI systems and those of any third-party provider without which there would be a material impact on critical SCI systems;
- A program to require a broker-dealer's clients to participate in BC/DR exercises;
- A program to prevent unauthorized access to SCI systems and information therein;
- A program to identify current SCI industry standards with which each such policy and procedure is consistent, if any; and
- A program to review its programs on an annual basis.

These requirements are in addition to other existing obligations such as those imposed by SEC Rule 15c3-5 and FINRA Rule 4370, which require that each broker-dealer create and maintain a written business continuity plan identifying procedures relating to an emergency or significant business disruption that are reasonably designed to enable them to meet their existing obligations to customers. Regulation SCI, if imposed on broker-dealers, would go further and require plans that include geographically diverse redundancy programs that ensure next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption in all cases irrespective of the severity of the disruption. These requirements are without regard for whether the role of a broker-dealer is in fact critical and systemically important to the orderly functioning of the market, which is unlikely to be the case as most market participants today typically utilize multiple brokers for competition and resiliency purposes.

Regulation SCI also imposes a complex reporting framework that is not fit for non-systemically important entities like broker-dealers. Regulation SCI calls for systemically important entities to notify the Commission of SCI events including, among other things, requirements to:

- Provide immediate notice for certain "SCI events";
- Provide a written notification on Form SCI within 24 hours that includes a description of the SCI event and the system(s) affected, with other information required to the extent available at the time;
- Provide regular updates regarding the SCI event until the event is resolved;
- Submit a final detailed written report regarding the SCI event; and
- Submit quarterly reports of all other events that are deemed di minimis events.

The Proposal would also impose on broker-dealers an obligation to report 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.

Finally, the Proposal would impose yet another annual review and certification requirement in addition to the review and certification required by SEC Rule 15c3-5 and FINRA Rule 3130. If imposed on broker-dealers, the costs in terms of additional human resources, hours, hardware, and other expenses would be extraordinary. To illustrate the absurdity of the Commission's cost estimates, the Commission projects that each new SCI entity would expend 890 hours to come into compliance with the Rule. Translated into eight-hour (8) days over a traditional work year of approximately two-hundred and sixty (260) workdays, the costs would be approximately one hundred and eleven (111) days. First the Commission suggests that these hours would be expended by a Chief Compliance Officer, a Compliance Manager, a Compliance Director, an Attorney, a Senior Systems Analyst, and a Senior Operations Specialist.[11] Anyone who has worked in this industry knows that these estimates are not realistic and are grossly understated. At a minimum for a firm like Virtu, rather than the six (6) roles described by the Commission in its estimates, the number of roles would be at least three (3) times that number including the Chief Information Security Office, Senior Infra-Structure Engineers, Software Developers, and countless other personnel. And, while all these employees are spending one hundred and eleven (111) days on Regulation SCI work required by the Proposal, who will do the work that these employees already do? Of course, the Commission expects that Regulation SCI broker-dealers will simply hire more people. In addition, we anticipate that Regulation SCI broker-dealers will be required to establish a completely redundant technology stack and infrastructure (servers, switches, datacenter space, circuits, storage, client connectivity, etc.). Who will bear all these extra costs? Investors and shareholders of course.

We are perplexed about the Commission's justification for advancing the Proposal. It is an incontrovertible fact that, unlike exchanges, SIPs, and registered clearing agencies, a broker-dealer does not represent a single point of failure that would severely disrupt the operation of the securities markets. This is because the level of competition and substitutability that exists among broker-dealers does not exist among the systemically important entities that Regulation SCI was designed to address.

In light of prior SEC pronouncements, such as the Commission's Frequently Asked Questions Regarding Regulation SCI, in which the Commission stated that the definition of critical SCI systems was designed to identify SCI systems whose functions may represent potential single points of failure in the securities markets,[12] one is left wondering what has changed that warrants the imposition of Regulation SCI on broker-dealers. Perhaps, the Commission should ask itself

[11] Proposal at 205.

[12] SEC Division of Trading and Markets, *Responses to Frequently Asked Questions Concerning Regulation SCI* (Sept. 2, 2015, updated Aug. 21, 2019), available at https://www.sec.gov/divisions/marketreg/regulation-sci-faq.shtml.

whether Regulation SCI as it is currently formulated has delivered the supposed benefits it sought to deliver. It is abundantly clear, however, that there is no justification under the law or in practice that necessitates the imposition of Regulation SCI on participants that do not represent single points of failure, such as broker-dealers. We are therefore left with what may be the true impetus for the Proposal – to again seek to remove wholesalers from the market ecosystem and stifle competition among market participants in favor of exchanges.

III. The Commission Has Failed to Satisfy Its Obligations Under the Law to Identify a Market Failure that Needs to Be Addressed and to Conduct an Adequate Cost-Benefit Analysis

Perhaps the most substantial defect of the Proposal is that the Commission has failed to satisfy its obligations under the law to:

- identify a market failure that needs to be addressed,
- articulate a satisfactory explanation for its action,
- consider the alternative of not regulating, and
- assess all of the significant costs and risks of the Proposal – including the substantial harm to investors inflicted by the proposed rules.

Importantly, the Commission has also failed to meet its obligation to adequately identify and quantify the benefits to investors and the markets that would flow from the Proposal and bases its inclusion of new Regulation SCI entities within the scope of the rule on arbitrary quantitative thresholds that bear no relation to the risks that the Commission purportedly is trying to address. These defects render the Proposed Rule arbitrary and capricious.

a. The Commission's Obligation to Identify a Market Failure is Clearly Established by Statute, Executive Branch Orders, the Commission's Own Guidance, and Binding Federal Jurisprudence

The Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, (the "Exchange Act") expressly requires the Commission to consider, as part of the rulemaking process, "the impact any . . . rule or regulation would have on competition," and may not adopt any "rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of" the securities laws.[13] In addition, whenever the Commission is engaged in rulemaking generally "and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."[14]

[13] 15 U.S.C. § 78(w)(a)(2).
[14] 15 U.S.C. § 78c(f); *see id.* § 80a-2(c).

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Circuit courts have repeatedly interpreted the above and similar statutory provisions, as well as general requirements under the Administrative Procedure Act, to require that the Commission conduct an economic analysis of any proposed rule.

> [T]he Commission has a unique obligation to consider the effect of a new rule upon "efficiency, competition, and capital formation," 15 U.S.C. §§ 78c(f), 78w(a)(2), 80a-2(c), and its failure to "apprise itself—and hence the public and Congress—of the economic consequences of a proposed regulation" makes promulgation of the rule arbitrary and capricious and not in accordance with law. (citation omitted). . . . [T]he Commission acted arbitrarily and capriciously for having failed . . . adequately to assess the economic effects of a new rule. Here, the Commission inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters.[15]

Further, courts have admonished that when agencies are charged with conducting an economic analysis, "it is a small matter to abide by the injunction of the arithmetic teacher: Show your work!"[16] As the Supreme Court has explained, an agency's most fundamental responsibility in issuing a rule is to "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[17]

Executive Order 12866 sets forth the standards that federal agencies should follow when conducting a cost-benefit analysis required under the law:

> Federal agencies should promulgate only such regulations as are required by law, are necessary to interpret the law, or are made necessary by compelling public need, such as material failures of private markets to protect or improve

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[15] *Business Roundtable*, 647 F.3d at 1148–49. For example, in *Am. Equity Inv. Life Ins. Co.* v. *SEC*, 613 F.3d 166, 178 (D.C. Cir. 2010), the court found that the SEC acted arbitrarily and capriciously when it failed to make a finding about the existing level of competition in the marketplace. Although the Commission urged that its rule would increase competition, the court found that, without first developing an understanding of the existing competition levels, the Commission "could not accurately assess any potential increase or decrease in competition." *Id.* In *Chamber of Commerce* v. *SEC*, 412 F.3d 133, 144–45 (D.C. Cir. 2005) the court found that the Commission violated the APA and failed to discharge its "statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation" and to consider non-frivolous alternatives. It was not enough that the Commission disclosed difficulties determining certain costs or that it was without a "reliable basis" for determining those costs. *Id.* (internal quotation marks omitted). Finally, in *Am. Petroleum Inst.* v. *SEC*, 953 F. Supp. 2d 5, 22–23 (D.D.C. 2013), the court found that the Commission failed to adequately consider alternatives when it simply dismissed proposed alternatives as too broad. It should have considered tailored versions of those alternatives and conducted a "fuller analysis" of alternatives "given the proportion of the burdens on competition" by the proposed rule. *Id.* at 23.

[16] *City of Holyoke Gas & Elec. Dep't* v. *FERC*, 954 F.2d 740, 743 (D.C. Cir. 1992).

[17] *Motor Vehicle Mfrs. Ass'n of U.S. Inc.* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (*quoting Burlington Truck Lines* v. *United States*, 371 U.S. 156, 168 (1962)).

> the health and safety of the public, the environment, or the well-being of the American people. In deciding whether and how to regulate, agencies should assess all costs and benefits of available regulatory alternatives, including ***the alternative of not regulating***… Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem.[18]

In the Proposal, the Commission has failed to identify any market failure involving broker-dealer systems that needs to be addressed and has not adequately considered the extensive framework of existing rules that apply to broker-dealers which should lead the Commission to choose the alternative of not regulating further.

Consistent with the principles outlined in the Executive Order, the Commission's Division of Risk, Strategy, and Financial Innovation – now known as the Division of Economic and Risk Analysis ("DERA") – and the Commission's Office of the General Counsel ("OGC") issued guidance in 2012 on economic analysis in Commission rulemakings. The guidance provides that:

> Rule releases ***must include a discussion of the need for regulatory action and how the proposed rule will meet that need***. In some circumstances, there will be more than one justification for a particular rulemaking. Frequently, the proposed rule will be ***a response to a market failure that market participants cannot solve because of collective action problems***. Traditional market failures include market power, externalities, principal-agent problems (such as economic conflicts of interest), and asymmetric information.[19]

Again, in the Proposal, the Commission has failed to identify a market failure that needs regulatory action, nor has the Commission articulated a problem that cannot be solved by the marketplace because of collection action problems.

At the November 10, 2022, SIFMA Equity Market Conference,[20] Dr. Jessica Wachter, Ph.D., the current Director of DERA underscored the importance of this guidance, explaining that

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[18] Executive Order 12866, 58 F.R. 51735, Regulatory Planning and Review (Sept. 30, 1993), *available at* https://www.archives.gov/files/federal-register/executive-orders/pdf/12866.pdf (emphases added). As an independent regulatory agency, the Commission is not legally bound by the requirements in Executive Order 12866. The Commission has acknowledged, however, that these principles represent accepted standards of good practice in conducting rulemaking proceedings. *See* Current Guidance on Economic Analysis in SEC Rulemakings at 3–4 (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[19] Current Guidance on Economic Analysis in SEC Rulemakings, *supra* note 18, at 5 (emphasis added).

[20] During the 2022 SIFMA Equity Market Conference, which consisted of a diverse industry audience, 93% of participants who were polled did not believe it was a good idea for the SEC to require auctions in equities markets for retail orders. *See* SIFMA Insights, The 2022 Market Structure Week Debrief, at 14 (Nov. 2022), *available at* https://www.sifma.org/wp-content/uploads/2022/11/SIFMA-Insights-Market-Structure-Debrief-2022-FINAL.pdf.

identifying a market failure that needs to be addressed is "Step 1" in DERA's process in conducting an economic analysis of a rulemaking.

We respectfully submit, that in issuing the Proposal, the Commission has wholly failed to satisfy its obligations under the Exchange Act, Executive Order 12866, the Commission's own administrative guidance, and general obligations under the APA and relevant caselaw to identify a market failure that needs to be addressed, to articulate a satisfactory explanation for its action, to consider the alternative of not regulating, and to assess all of the significant costs and risks of the Proposal – including the substantial harm to investors inflicted by the proposed rules. The Proposal also fails to adequately – or even superficially – assess the harmful burdens on competition that the contemplated amendments would impose. Its failure to meet these obligations renders the Proposed Rule arbitrary and capricious and violative of law.

b. The Commission's Economic Analysis Fails to Justify the Extraordinary Costs and Burdens that the Proposal Would Impose on Broker-Dealers

We agree strongly with Commissioner Peirce's observation that the Proposal's cost estimate for newly covered entities is nothing short of "staggering".

> "The projected costs are staggering: the Paperwork Reduction Act estimates alone reach almost $50 million for ongoing annual costs for all affected firms, but they still seem to grossly underestimate the costs of implementing and maintaining policies and procedures and making newly mandated reports. The economic analysis attempts to quantify some of the non-PRA costs but leaves many others unquantified, including some that are likely to be the most significant and disrupting, including the costs of renegotiating agreements with third-party service providers, monitoring those providers, agreeing to higher charges as providers grapple with the additional costs of doing business with these registrants, and potentially shifting business to different third-party providers or building out certain in-house capabilities to replace those providers." [21]

As Commissioner Peirce points out, the estimates fail to specifically address or calculate the overwhelming compliance and implementation costs that would be borne by newly affected entities. To comply with the Proposal, broker-dealers would incur very substantial monitoring, reporting, technological development and infrastructure, capital expenditure, and third-party vendor costs, none of which are estimated with any support in the Proposal. Not only does the Proposal fail to adequately and completely address the enormous compliance costs that would be borne by new SCI entities, it also fails to justify those costs given there is no evidence that an expansion of Regulation SCI would provide benefits to the market or is necessary to address a market failure or that such an expansion would benefit the integrity of broker-dealer systems beyond what is achieved by existing FINRA and SEC rules.

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[21] Commissioner Hester Pierce, *Comments on Proposed Expansion of Regulation SCI* (Mar. 15, 2023), *available at* https://www.sec.gov/news/statement/peirce-statement-regulation-sci-031523.

We are left questioning whether the Proposal's goal is to enhance the integrity of broker-dealer systems or of the broader marketplace. If it is the latter, it is not clear how the Proposal will help. Indeed, the Commission readily admits that it does not have the information it needs to estimate the costs and benefits that would accrue from the Proposal:

> "In many cases it is difficult to quantify the economic effects, particularly those beyond the costs estimated in the Paperwork Reduction Act analysis. As explained in more detail below, ***the Commission in certain cases does not have, and does not believe it can reasonably obtain, data or information necessary to quantify certain effects***. For instance, ***the Commission finds it impracticable to quantify many of the benefits associated with amended Regulation SCI***. Indeed, we ***lack information that would allow us to predict the reduction in frequency and severity of SCI events or the specific cost savings that might arise*** from avoiding the harm Regulation SCI is designed to prevent. Further, even in cases where the Commission has some data, ***quantification is not practicable*** due to the number and type of assumptions necessary to quantify certain economic effects, which render any such quantification unreliable."[22]

Similar to other rule proposals submitted by the Commission over the last two years, the Commission also has failed to identify and quantify the potential benefits of extending Regulation SCI to new market participants. The Commission's cost-benefit analysis is deficient in that it admittedly fails to include a comprehensive analysis of the costs and burdens that would be imposed or even that SROs experienced in implementing the 2014 rule. The SROs incurred very substantial costs in initial systems buildouts, mapping exercises, and ongoing monitoring and reporting obligations in addition to increased recurring technology expenditures. The Proposal's failure to take into account analogous costs and burdens that would be experienced by broker-dealers renders the Commission's cost-benefit analysis inadequate to support moving forward with a final rule.

c. The Proposed Asset and Trading Thresholds are Inappropriate and Arbitrary

To determine which entities would be included in the newly expanded definition of covered Regulation SCI entities, the Proposal contemplates a completely arbitrary two-part test that would capture entities that either (i) exceed either a total assets threshold or (ii) exceed a transaction activity threshold. Specifically, under the Proposals, SCI entities would include broker-dealers with five percent (5%) or more of the total assets of all security brokers and dealers, as well as broker-dealers that transact average daily dollar volume equal to ten percent (10%) or more of the average daily dollar volume in the marketplace.[23]

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[22] Proposal at 282-283. Of note, we did not identify any documentation in the Proposal of the frequency or severity of SCI events that are happening today at broker-dealers, so it is not surprising that the Commission lacks the ability to predict how the Proposal might lead to a reduction in such events.
[23] Proposal at 54-55.

It seems clear that the Commission's leadership was bound and determined to push the Proposal out the door, even though its staff was unable to substantiate a need. For example, the Proposal relies on arbitrary quantitative thresholds that bear no relationship to the goals that the Commission is purportedly trying to achieve with its contemplated amendments. Specifically, the Commission has failed to explain why either the total assets threshold or transaction activity threshold tests are a proxy for activities that should be subject to Regulation SCI. The mere fact that a broker-dealer holds a certain level of assets or engages in a certain level of transaction activity does not mean that the broker-dealer is engaged in a critically important function within the market or that a systems outage at the broker-dealer would pose a substantial risk to the maintenance of fair and orderly markets.

The use of quantitative tests to determine who is subject to costly and burdensome regulatory obligations is particularly troubling because it replaces a thoughtful and deliberate qualitative consideration of an entity's activities and potential risks to the marketplace with a blunt, bright-line threshold where an arbitrary level of trading volume or assets is determinative. Unnuanced bright-line tests that are incapable of taking into account the facts and circumstances of a particular entity's activities can result in inappropriate and unintended outcomes.

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Rather than moving forward with this misguided Proposal that would inappropriately subject broker-dealers to burdensome and costly regulatory requirements that are not thoughtfully tailored to them, the Commission should instead conduct a review of the many SEC and FINRA rules that broker-dealers are already obligated to follow that, collectively, require them to invest in technology and compliance resources that have resulted in unprecedented systems integrity over the last decade. As part of that review, the Commission should also take into consideration its various proposals that have yet to be finalized that would further ensure that broker-dealers have robust systems and controls in place to guard against technology outages. Furthermore, the Commission should also consider (i) how competition between brokers also incentivizes them to invest in system reliability and product enhancements, and (ii) how easy it is for investors to switch brokers (i.e., mouse click) and how many investors already have multiple brokers.

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Unless and until the Commission identifies a market failure that needs to be addressed – or, at the very least, until the Commission is able to quantify the benefits of the proposed expansion of Regulation SCI – it should refrain from subjecting an entire class of market participants to new rules that are ill-suited to mitigate broker-dealer technology risk. As described in detail above, the Proposal dramatically misses the mark in that it fails to recognize that, unlike systemically important entities, as defined by Regulation SCI such as exchanges, SIPs, and registered clearing agencies, broker-dealers are competitive substitutes for each other and therefore are not critical components of the market infrastructure that should be subject to the requirements of Regulation SCI.

Respectfully submitted,

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cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
The Honorable Mark T. Uyeda, Commissioner
The Honorable Jaime E. Lizarraga, Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets