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TECHNOLOGY OUTSOURCING BY NATIONAL SECURITIES EXCHANGES AND REGISTERED CLEARING AGENCIES

Outsourcing of technology systems plays an important role for national securities exchanges and registered clearing agencies, but raises securities law compliance issues. After providing a regulatory framework for outsourcing, the author discusses compliance considerations when national securities exchanges and registered clearing agencies decide to outsource their technology systems, including compliance obligations under Regulation SCI. In this context, she discusses the importance of risk assessment of the outsourcing decision, due diligence on the prospective third party, and management of the third-party relationship, to ensure regulatory compliance, through contractual terms, ongoing monitoring, and oversight, among other means. She closes with considerations for the third-party service provider.

By Wenchi Hu *

Outsourcing — the use of third-party service providers to perform certain activities, functions, processes, or services in place of producing such internally — is widely utilized and, in many instances necessary, for an operating entity to perform its activities and functions. As technology develops and advances, outsourcing may not only be used for resource management and cost savings, but also to leverage new technology and third-party expertise that enables the business to operate in a way that would not otherwise be possible.

Unique issues and challenges arise when a regulated entity contemplates outsourcing any of its activities and functions to a third party. Questions to be answered include: Can the regulated entity outsource the particular activity or function? If so, to whom can it be outsourced? Who is legally responsible for regulatory compliance after outsourcing, and how should it comply with regulatory requirements in the outsourcing arrangements? It would typically be prudent to answer these questions before heavy investments are made and binding contractual outsourcing arrangements are entered into. Given that the operation of many regulated entities rely heavily on technology systems and leverage third parties' technological expertise, technology

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outsourcing plays an important role in the operation of financial institutions, markets, and market infrastructures. This paper discusses these issues in the context of technology outsourcing by a national securities exchange (hereinafter "securities exchange") or registered clearing agency (hereinafter "clearing agency").

OUTSOURCING IN GENERAL BY SECURITIES EXCHANGES AND CLEARING AGENCIES

The regulatory framework regarding registration and regulation of securities exchanges and clearing agencies in the Securities Exchange Act of 1934, as amended (together with rules and regulations thereunder, "Exchange Act"), provides a starting point to consider the issues and limitations related to outsourcing by a securities exchange and clearing agency.

a. Outsourcing Self-Regulatory Functions

A securities exchange and clearing agency are self-regulatory organizations ("SROs"),[1] and as such are required to perform self-regulatory functions and to comply with the requirements under Section 19 of the Exchange Act. Among other things, Section 19(b) requires every SRO to file proposed rule changes with the SEC, and Section 19(g)(1) requires every SRO, absent reasonable justification or excuse, to enforce compliance with the Exchange Act and the SRO's own rules by its members and persons associated with its members or by its participants, which includes reviewing applications for membership and performing examination, enforcement or disciplinary functions, subject to limited exceptions.[2]

The self-regulatory functions and responsibilities set forth in Section 19 of the Exchange Act are attendant to the SRO status as a registered entity and an SRO has not been permitted under the regulatory framework to outsource its self-regulatory functions or responsibilities to a person that is not an SRO. However, an SRO may contract with another SRO to perform certain self-regulatory functions if the contractual agreement, with respect to provision of regulatory services, is consistent with the Exchange Act and the public interest.[3] The SEC in several instances has found that it was consistent with the Exchange Act and the public interest for an SRO to contract with other SROs to perform certain self-regulatory responsibilities and functions, such as membership, examination, enforcement, and disciplinary functions that are fundamental elements of a regulatory program and constitute core self-regulatory functions, if the SRO retained to perform contractual services has the capacity to perform them.[4]

In each of these instances, pursuant to a regulatory service agreement between two SROs, the SRO retained

[1] Section 3(a)(26) of the Exchange Act, 15 U.S.C. 78(c)(a)(26).

[2] Section 19(g)(2) of the Exchange Act, 15 U.S.C. 78s(g)(2) (providing that the SEC, by rule, may relieve any SRO of any responsibility to enforce compliance with the Exchange Act by any member of the SRO) and Section 17(d)(1) of the Exchange Act, 15 U.S.C. 78q(d)(1) (providing that the SEC, by rules or order, may relieve an SRO of certain self-regulatory responsibility, as discussed in more detail below).

[3] *See, e.g.*, Regulation of Exchanges and Alternative Trading Systems, Exchange Act Rel. No 409760 (December 8, 1998), 63 FR 70844, 70882 (December 22, 1998) (stating that the SEC will consider whether allowing the exchange to contract with another SRO to perform its day-to-day enforcement and disciplinary activities would be consistent with the public interest); *see* also Exchange Act Rel. No. 42455 (February 24, 2000), 65 FR 11388, 11393 (March 2, 2000)(stating that contractual regulatory agreements between SROs outside of the Rule 17d-2 context may be permissible where it is consistent with the public interest) and Exchange Act Rel. No. 50122 (July 29, 2004), 69 FR 47962, 47963 (August 6, 2004).

[4] *See, e.g.*, Exchange Act Rel. No. 57478 (March 12, 2008), 73 FR 14521, 14536 (March 18, 2008) (finding NASDAQ Stock Market LLC's contract with Financial Industry Regulatory Authority ("FINRA") to perform certain SRO functions consistent with the Exchange Act and the public interest); Exchange Act Rel. No. 53128 (January 13, 2006), 71 FR 3550 (January 23, 2006) ("Nasdaq Order") (finding Nasdaq Stock Market, LLC's contract with NASD Regulation to perform certain SRO functions consistent with the Exchange Act and the public interest); Exchange Act Rel. No. 58375 (August 18, 2008), 73 FR 49498, 49503 (August 21, 2008) ("BATS Order")(allowing BATS Exchange Inc. to contract with FINRA to perform SRO functions); and Exchange Act Rel. No. 79543 (December 13, 2016), 81 FR 92901 (December 20, 2016)("MIAX PEARL Order").

to perform contractual regulatory services ("operating SRO") would operate pursuant to the self-regulatory responsibilities of the contracting SRO (which was a securities exchange) under Sections 6 and 19 of the Exchange Act and would apply the contracting SROs' rules. The action taken by the operating SRO, its respective employees, or authorized agents pursuant to the regulatory service agreement would be deemed an action taken by the contracting SRO. The contracting SRO retains ultimate responsibilities for performance of its self-regulatory duties under the Exchange Act and bears the primary liability for self-regulatory failures, not the operating SRO that is retained to perform regulatory functions on behalf of the contracting SRO.[5]

Limited exceptions exist under Section 17(d)(1) of the Exchange Act[6] that allow the SEC to relieve an SRO of self-regulatory responsibilities with respect to members of such SRO who are also members of another SRO. Pursuant to this statutory provision, the SEC adopted Rules 17d-1 and 17d-2 to allow it to designate by notice one SRO as the designated examination authority to bear the responsibility for examination of a common broker-dealer member of more than one SRO for compliance with applicable financial responsibility rules,[7] and to allow two or more SROs to propose a joint plan to allocate among them self-regulatory responsibilities for their common rules with respect to their common members. Such joint plan, when approved and declared effective by the SEC, would relieve the specified SRO(s) of those regulatory responsibilities allocated by the plan to another SRO.[8]

b. Outsourcing Arrangements Not Involving Self-Regulatory Functions

In outsourcing arrangements that do not involve contracting a third party to perform self-regulatory functions, the Exchange Act on its face does not appear to prohibit outsourcing, and it may be permissible for a securities exchange to contract a third party to perform its non-SRO activities, such as operating its facilities, or for a clearing agency to outsource certain of its clearance and settlement systems.[9] However, a securities exchange or clearing agency should consider whether the outsourcing arrangement is consistent with the Exchange Act requirements applicable to it, and how it would affect its obligation to comply with the Exchange Act requirements and its own rules.[10] For example, in circumstances where a national securities exchange or registered clearing agency delegates or transfers activities to a third-party service provider in a way that results in that service provider being engaged in activities that would cause it to be viewed as operating the exchange or performing the function of the clearing agency, such outsourcing arrangement may not be consistent with the Exchange Act or its own rules, and could potentially be a violation of Section 19(g)(1) of the Exchange Act. It is also important to consider whether it is required to file a proposed rule change (or include the outsourcing arrangement as part of a proposed rule change required to be filed) before entering into the outsourcing arrangement.[11] The SEC in the past has approved proposed rule changes that included outsourcing to non-SRO third-party service

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[5] *See, e.g.*, MIAX PEARL Order (stating that, unless relieved by the SEC of its responsibility under these statutory provision and rules, an SRO contracting with another SRO to perform certain regulatory functions that are fundamental elements of a regulatory program or core self-regulatory functions under a regulatory service agreement, bears the ultimate responsibility for self-regulatory responsibilities and primary liability for self-regulatory failures, not the SRO retained to perform regulatory functions on the contracting SRO's behalf.)

[6] 15 U.S.C. 78q(d)(1).

[7] *See* Rule 17d-1, 17 CFR 240.17d-1.

[8] Pursuant to Rule 17d-2, the SEC has issued orders approving multilateral and bilateral plans; examples of 17d-2 plans are *available at* https://www.sec.gov/rules/sro/17d-2.htm.

[9] *See* Section 3(a)(1) and Section 3(a)(23) of the Exchange Act for descriptions of the functions and activities of an "exchange" and "clearing agency".

[10] A securities exchange and clearing agency are subject to, and required to maintain continuous compliance with, the Exchange Act requirements, including Sections 6 (with respect to national securities exchanges), 17A (with respect to registered clearing agencies), 19(b), and 19(g)(1) of the Exchange Act, 15 U.S.C. 78f, 78q-1 and 78s, and the SEC rules.

[11] For example, if the outsourcing of the securities exchange or clearing agency operation constitutes a material aspect of the operation of facilities of the exchange or clearing agency, and is not reasonably and fairly implied by the existing rules, or concerned solely with the administration of the securities exchange or clearing agency, it may be a proposed rule change required to be filed with the SEC. Rule 19b-4(a)(6) "stated policy, practice, or interpretation" to include any material aspect of the operation of the facilities of the SRO). Rule 19b-4(c) provides that a stated policy, practice, or interpretation of the SRO shall be deemed to be a proposed rule change unless (1) it is reasonably and fairly implied by an existing rule of the SRO or (2) it is concerned solely with the administration of the SRO and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the SRO.

providers certain activities or functions that were not self-regulatory functions and that did not cause the third-party service providers to be viewed as operating an exchange or performing clearing agency functions without registration, and the SEC found the outsourcing arrangements consistent with the applicable Exchange Act requirements.[12]

Finally, in the context of a national market system plan ("NMS" plan)[13] approved by the SEC, the SROs that jointly established such plan may engage a third-party processor to operate the facilities contemplated by the effective NMS plan. Although this is not the same as a typical outsourcing arrangement, the contracting SROs must ensure that the third party complies with the plan, as approved by the SEC, and all the applicable Exchange Act requirements the contracting SROs and their facilities are subject to.

TECHNOLOGY OUTSOURCING BY SECURITIES EXCHANGES AND CLEARING AGENCIES

Securities exchanges and clearing agencies rely heavily on technology systems to perform their functions. These systems may be built, run, operated, maintained, and/or supported by other parties, including affiliates. In light of the statutory and regulatory framework discussed above, a few special considerations are noted here in respect of technology outsourcing by securities exchanges and clearing agencies.

First, technology systems outsourcing by a securities exchange or clearing agency may be permitted. Depending on the functions the technology systems are serving and the activity the third-party service provider will perform, technology systems outsourcing may be with an SRO as in the case of a regulatory service agreement (which may be an arrangement pursuant to Section 17(d)(1) of the Exchange Act and Rule 17d-2) or with a third-party service provider that is not an SRO. In each case, before entering into a technology systems outsourcing arrangement, a securities exchange or clearing agency should consider whether it is required to seek the SEC's approval, as in the case of a joint plan and regulatory service agreement under Section 17(d)(1) of the Exchange Act and Rule 17d-2, or a proposed rule change under Section 19(b) of the Exchange Act, and whether the outsourcing is consistent with the applicable Exchange Act requirements.

Second, unless the systems outsourcing is pursuant to a joint plan allocating regulatory responsibilities approved by the SEC under Section 17(d)(1) of the Exchange Act and Rule 17d-2, the contracting securities exchange or clearing agency continues to be responsible for its compliance and self-regulatory obligations. Questions follow as to whether the contracting exchange or clearing agency is obligated to take additional steps beyond selecting a capable third party to ensure compliance with regulatory requirements and avoid self-regulatory failures (in the case of regulatory service agreements). For example, would the contracting securities exchange or clearing agency have to maintain direct control over performance of the operating third party and manage third-party relationships in order to ensure regulatory compliance? In the past, the SEC has considered the expertise and experience of the operating SRO that would perform membership, discipline, and enforcement self-regulatory functions on behalf of the contracting SRO in determining whether the regulatory service agreement is consistent with the Exchange Act and the public interest when approving a proposed rule change relating to such agreement.[14] On the other hand, in the context of outsourcing to a non-SRO vendor, the SEC has considered the due diligence the contracting SRO conducted on the third-party vendor's control, governance, and data quality standards, and the contracting SRO's existing control framework for managing key risks, such as technology risk, business continuity, regulatory compliance, privacy controls, and conflicts of interest, as well as procedures for back-up

[12] *See, e.g.*, Exchange Act Rel. No 79868 (January 24, 2017), 82 FR 8780 (January 30, 2017) (approving a proposed rule change by the Fixed Income Clearing Corporation ("FICC") to implement a new methodology used in the MBSD VaR model, which incorporates market data and market risk attributes supplied by an external vendor) and Exchange Act Rel. No. 74456 (March 6, 2015) 80 FR 13055 (approving a proposed rule change to revise the ICE Clear Credit treasury operations policy, which includes the engagement of outside investment managers to invest guaranty fund and margin cash pursuant to ICE Clear Credit's USD and Euro investment guidelines).

[13] Rule 600(b)(43), 17 CFR §242.600(b)(43), defines "national market system plan" as any joint self-regulatory organization plan in connection with (i) the planning, development, operation, or regulation of a national market system (or a subsystem thereof), or one or more facilities thereof or (ii) the development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations and their members with any section of Regulation NMS and part 240, subpart A of chapter 17 promulgated pursuant to section 11A of the Exchange Act. A national market system plan must be approved by the SEC pursuant to Rule 608 under the Exchange Act, 17 CFR §242.608 in order to become effective. Rule 600(b)(21), 17 CFR §242.600(b)(21).

[14] *See, e.g.*, Exchange Act Rel. No. 57478, *supra* note 4.

measures should the vendor fail to perform. The SEC also considers how the contracting SRO would comply with Regulation Systems Compliance and Integrity ("Regulation SCI"),[15] when approving the proposed rule change with a significant outsourcing component.[16]

Finally, securities exchanges and clearing agencies are subject to Regulation SCI, which governs the technology systems of those entities falling within its scope (i.e., the "SCI entities").[17] Technology systems outsourcing by a securities exchange or clearing agency has implications for their compliance with Regulation SCI. The SEC in the adopting release of Regulation SCI,[18] and staff in its subsequent Responses to Frequently Asked Questions Concerning Regulation SCI,[19] provide guidance on the requirements and considerations for compliance when an SCI entity (which includes a securities exchange and clearing agency) outsources the operation of SCI Systems to third parties. Such guidance should be taken into account when considering how Regulation SCI applies and how to ensure compliance with Regulation SCI in the context of systems outsourcing.

In the context of a third-party processor operating the facilities of SROs pursuant to an effective NMS plan, as stated above, the contracting SROs that jointly established the plan must ensure that the third-party processor complies with the plan and applicable Exchange Act requirements to which the SROs and their facilities are subject. To the extent that the facilities contemplated by the effective NMS plan constitute the contracting SROs' SCI systems, the contracting SROs also should take the SEC's guidance and subsequent Staff's Guidance into account when considering its obligations of compliance with Regulation SCI with respect to the facilities operated by the third-party processor pursuant to the effective NMS plan.[20]

COMPLIANCE WITH REGULATION SCI

The existence of systems outsourcing was recognized by the SEC when it considered whether "SCI systems"[21] should include systems operated by a third party on behalf of an SCI entity and whether Regulation SCI requirements should apply to such third-party-operated systems. The SEC ultimately stated that any system that directly supports one of the six key functions of trading, clearance and settlement, order routing, market data, market regulation, and market surveillance with respect to securities is important to the functioning of the U.S. securities markets, regardless of whether it is operated by the SCI entity directly or by a third party. Therefore, permitting such systems to be excluded from the requirements of Regulation SCI would significantly

[15] 17 CFR 242.1000 – 1007.

[16] SR-FICC-2026-007, Exchange Act Rel. No 79491 (December 7, 2016), 81 FR 90001 (Notice of filing of proposed rule change by FICC to implement a change to the methodology used in the MBSD VaR model, which incorporates market data and market risk attributes supplied by an external vendor) and the associated approval order, Exchange Act Rel. No 79868, *supra* note 12.

[17] The definition of "SCI entity" in Rule 1000, 17 CFR 242.1000, includes any securities exchange (excluding an exchange that is notice registered with the SEC under Section 6(g) of the Exchange Act), registered securities association (excluding a limited purpose national securities association registered with the SEC under Section 15A(k) of the Exchange Act), registered clearing agency, the Municipal Securities Rulemaking Board, alternative trading system as defined in Rule 300(a) of Regulation ATS that meets certain requirements, plan processor, or exempt clearing agency whose exemption contains conditions that relate to the SEC's Automation Review Policies or any SEC regulation that supersedes or replaces such policies.

[18] Regulation of Systems Compliance and Integrity, Exchange Act Rel. No 73639 (November 19, 2014), 79 FR 72252 (December 5, 2014)("Regulation SCI Adopting Release").

[19] Division of Trading and Markets: Responses to Frequently Asked Questions Concerning Regulation SCI, September 2, 2015 (Updated December 8, 2016, hereinafter referred to as "Staff's Guidance"), *available at* https://www.sec.gov/divisions/marketreg/regulation-sci-faq.shtml.

[20] The third-party processor may be a plan processor as defined in Rule 600(b)(55), 17 CFR 242.600(b)(55), and therefore an SCI entity under Rule 1000, *supra* note 17, in which case such third party has obligations to comply with Regulation SCI with respect to its own SCI systems. Not every processor of an NMS plan is a plan processor. For example, the processor of the Symbol Reservation System associated with the National Market System Plan for the Selection and Reservation of Securities Symbols (File No. 4-533) and the processor of the Consolidated Audit Trail associated with the National Market System Plan Governing the Consolidated Audit Trail (File No. 4-698) are not "plan processors" defined in Rule 600(b)(55), because they are not involved in collecting, processing, and preparing for distribution transaction and quotation information.

[21] Rule 1000, 17 CFR 242.1000, defines "SCI systems" as 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.

reduce the effectiveness of the regulation.[22] The SEC further stated that an SCI entity, if it determines to utilize a third party for an applicable system, is responsible for having in place processes and requirements to ensure that it is able to satisfy the requirements of Regulation SCI for SCI systems operated on its behalf by the third party.[23]

At a high level, this means that to ensure compliance with Regulation SCI, a securities exchange or clearing agency should consider establishing policies and procedures to require risk assessment of an outsourcing decision, due diligence on third parties, and management of third-party relationships through contractual terms, monitoring procedures, or other methods.[24] These are discussed below.

a. Risk Assessment and Due Diligence

In practice, the policies and procedures may, for example, require the contracting SCI entity to conduct a risk assessment to evaluate the risk that would arise from outsourcing in general and specifically with respect to the prospective third-party service provider, and consider how it will manage such risk prior to entering into the outsourcing arrangement to ensure compliance with Regulation SCI.[25] The risk assessment may be designed to evaluate those risks arising from outsourcing that affect the contracting SCI entity's ability to comply with the Exchange Act requirements, and therefore affecting compliance with Regulation SCI. These risks include operational risk, and other risks beyond regulatory compliance, such as reputation risk, as part of prudent risk management.

The policies and procedures may also require the risk assessment to evaluate the challenges associated with oversight of third-party service providers that provide or support the SCI systems and the contracting SCI entity's ability to manage the third-party relationship through appropriate due diligence, contract terms, monitoring, or other methods to satisfy the regulatory requirements. This highlights the importance of performing due diligence on prospective third-party service providers prior to selection and entering into the outsourcing contract. The due diligence may include not only the service provider's tangible information, such as financial status, delivery capability, technology and systems architecture, internal controls, security history, and audit coverage, but also intangible elements like corporate governance, culture, service philosophies, quality initiatives, and management style.[26] The culture, values, and business styles of the service provider, if they do not

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[22] Regulation SCI Adopting Release, 79 FR at 72275-72276. In various places of the Regulation SCI Adopting Release, the SEC disagreed with commenters that Regulation SCI requirements should not apply where an SCI entity uses a third party to operate its system and made it clear that the definition of SCI systems, as adopted, does not exclude third-party systems from the definition, 79 FR at 72324-72325 and 72356.

[23] Regulation SCI Adopting Release, 79 FR at 72276. Although the SEC's statement here focuses on compliance with the requirements of Regulation SCI for SCI systems operated on behalf of an SCI entity by a third party, this essentially means that an SCI entity is responsible for having in place processes and requirements to ensure compliance with all the regulatory requirements for SCI systems, because Rule 1001(b) of Regulation SCI requires each SCI entity to establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems operate in a manner that complies with the Exchange Act and the SCI entity's rules and governing documents, as applicable.

[24] For example, an SCI entity should consider establishing, maintaining, and implementing vendor risk policies reasonably designed to address risks arising from outsourcing for purposes of compliance with Regulation SCI. Policies and procedures will be deemed to be reasonably designed if they are consistent with current SCI industry standards. Rule 1001(a)(4). SEC staff has identified FFIEC, Outsourcing Technology Services IT Examination Handbook (June 2004), *available at*: https://ithandbook.ffiec.gov/ITBooklets/FFIEC_ITBooklet_OutsourcingTechnologyServices.pdf as an example of current SCI industry standards. See Staff Guidance on Current SCI Industry Standards, November 19, 2014, at 8, available at https://www.sec.gov/rules/final/2014/staff-guidance-current-sci-industry-standards.pdf.

[25] Regulation SCI requires, among other things, that the SCI entities establish, maintain, implement, and enforce policies and procedures reasonably designed to ensure that SCI systems have adequate levels of capacity, integrity, resiliency, availability, and security, and that the SCI systems operate in a manner that complies with the Exchange Act and the SCI entity's rules and governing documents. In addition, with respect to registered clearing agencies, Rule 17Ad-22(d)(4), 17 CFR 240.17Ad-22(d)(4) and, with respect to a covered clearing agency, Rule 17Ad-22(e)(17), 17 CFR 240.17Ad-22(e)(17) also contain requirements to establish, implement, maintain, and enforce written policies and procedures reasonably designed to, among other things, implement systems that are reliable, resilient, and secure, have adequate, scalable capacity, and have business continuity plans that allow for timely recovery of operations and fulfillment of a clearing agency's obligations. These rules are designed to achieve substantially the same objectives as Regulation SCI.

[26] *See*, *e.g.*, FFIEC, Outsourcing Technology Services IT Examination Handbook (June 2004), *supra* note 24, on risk assessment and service provider selection.

fit those of the contracting SCI entity, may present challenges to the oversight and management of the third-party relationship. The SEC states that if an SCI entity is uncertain of its ability to manage a third-party relationship (whether through appropriate due diligence, contract terms, monitoring, or other methods) to satisfy the requirements of Regulation SCI, it would need to reassess its decision to outsource the applicable system to such party.[27]

b. Outsourcing Contract terms

The policies and procedures may also include certain requirements with respect to the outsourcing contract terms. For example, the contract for the outsourcing arrangement may contain terms to recognize the role of an SCI entity, such as a securities exchange and clearing agency, in the national market system and the national clearance and settlement system and its respective obligations under the Exchange Act, so that the third party understands that it is contracting with a regulated entity and agrees that it would perform its contractual obligations consistent with the SCI entity's regulatory responsibilities and compliance obligations. The contractual terms may also require that the performance of the third-party's services or delivery of the third-party's work product be conforming to and consistent with the applicable regulatory standards and requirements and that the third-party service provider take certain initial steps to facilitate the SCI entity's compliance with the regulatory requirements because of the third-party's expertise, direct access to systems, and possession of more timely information. For example, the third party may take the initial steps for establishing the policies and procedures required under Regulation SCI for the relevant SCI system(s), draft a notification of an SCI event[28] required by Rules 1002(b)(2)-(4), draft the reporting of systems changes pursuant to Rule 1003(a), or take certain corrective actions required by Rule 1002(a) following an SCI Event and notify the SCI entity of the SCI Event and the action to be taken.

In addition, in order to comply with the recordkeeping requirement in Regulation SCI,[29] the contracting SCI entity may through contractual terms require the third party to preserve relevant records for a specified period of time and promptly furnish such records to any SEC representative upon request.

The contract terms may also enable the contracting SCI entity to monitor and subject the third-party's performance of the contract to its ongoing oversight to ensure regulatory compliance. For example, the contract may provide that the contracting exchange or clearing agency maintain the right to request relevant documents, and perform regulatory audit and inspections.[30]

c. Ongoing due diligence, monitoring, and oversight

As stated above, a securities exchange or clearing agency outsourcing its SCI systems to a third party may require the third party to take certain initial steps to facilitate its meeting certain obligations of Regulation SCI through contractual terms. The SEC staff states that the contracting SCI entity may rely on the operating third-party's initial steps to help facilitate its compliance with Regulation SCI if the reliance is reasonable and the contracting SCI entity exercises appropriate due diligence. One way of supporting the contracting SCI entity's reliance may be to require the operating third party to provide certain attestations as to compliance with the contractual terms and Regulation SCI requirements.[31] However, the SEC staff states that it does not believe it would be sufficient for the contracting SCI entity to solely rely on representations of the third party with respect to the adequacy of its policies and procedures, or to merely assume they are being maintained and enforced by the third party in accordance with Regulation SCI.[32] Instead, what constitutes appropriate due diligence to justify an SCI entity's reliance on the third party entails ongoing monitoring and oversight over the third-party's

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[27] *See* Regulation SCI Adopting Release, 79 FR at 72276.

[28] *See* Rule 1000, 17 CFR 242.1000, defining "SCI event" as an event at an SCI entity that constitutes a systems disruption, a systems compliance issue, or a systems intrusion. Rule 1000 defines "systems disruption" as an event in an SCI entity's SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system; "systems compliance issue" as an event at an SCI entity that has caused any SCI system of such entity to operate in a manner that does not comply with the Exchange Act, the entity's rules or governing documents; and "systems intrusion" as any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity.

[29] Rule 1005(a), 17 CFR 242.1005(a), providing that an SCI SRO shall make, keep, and preserve all documents relating to its compliance with Regulation SCI as prescribed in Rule 17a-1, 17 CFR 240.17a-1, under the Exchange Act.

[30] Staff's Guidance, at 6 (staff stating that it believes it is important that the contracting SCI entity maintain the right, i.e., in its contractual arrangements with the third party, to request relevant documents and perform regulatory inspections or audits).

[31] *Id*.

[32] *Id*.

performance of the contract by the SCI entity. Examples of appropriate due diligence by an SCI entity include[33]:

- reviewing the policies and procedures developed by the third-party service provider;
- discussing any concerns it identifies with the third party, and working with the third party to ensure that the policies and procedures comply with regulatory requirements including Regulation SCI;
- periodically reviewing the maintenance and enforcement of the policies and procedures by the third party, including through assessing the reports of SCI reviews, which should include any weaknesses in such policies and procedures; and
- incorporating the policies and procedures of the third party into the SCI entity's own policies and procedures, and detailing its policies and procedures for conducting appropriate due diligence and overseeing the performance of the third party under Regulation SCI.

All of the above reinforce the notion that, where an SCI entity utilizes a third party to operate SCI systems on its behalf, the contracting SCI entity remains responsible for ensuring compliance with Regulation SCI with respect to the SCI systems.

CERTAIN CONSIDERATIONS FOR THIRD-PARTY SERVICE PROVIDERS

Finally, from the third-party service provider's perspective, the third party should note the differences between contracting with a securities exchange or clearing agency vis-à-vis a non-regulated entity. In past instances where an SRO contracted its self-regulatory functions to another SRO pursuant to a regulatory service agreement, the SEC has stated that, if failings by the SRO retained to perform regulatory functions have the effect of leaving a securities exchange in violation of any aspect of the exchange's self-regulatory obligations, the SRO retained to perform regulatory functions may bear liability for causing or aiding and abetting the violation.[34] By the same token, when a securities exchange or clearing agency contracts its technology systems that are SCI systems to a third party, the contractual relationship cannot alter or otherwise vitiate the securities exchange's or clearing agency's obligation to comply with applicable Exchange Act requirements, and therefore, the contractual terms must be consistent with these requirements, which may result in certain limitations on the third-party contractual rights or remedies that would differ from those contractual terms with a non-registered entity.

In addition, a third party in an outsourcing arrangement with a securities exchange or clearing agency should consider avoiding being engaged in activities in a way that results in itself being viewed as operating exchange facilities or performing clearing agency functions without registration.[35] Whether a third-party's activities in an outsourcing arrangement would constitute acting as a securities exchange or clearing agency, will depend on the specific facts and circumstances. Parties should consider consulting regulatory counsel when entering into outsourcing contracts with national securities exchanges or registered clearing agencies. ■

[33] *Id.*

[34] *See e.g.*, MIAX PEARL Order, 81 FR at 92909; Nasdaq Order, 71 FR at 3556; and BATS Order, 73 FR at 49503.

[35] Under the Exchange Act, operating or maintaining facilities to provide a market place for effecting transactions in securities and reporting such transactions via means in interstate commerce can only be performed by a national securities exchange. *See* Sections 3(a)(1) and 5 of the Exchange Act, 15 U.S.C. 78c(a)(1) and 78e. Similarly, activities such as acting as an intermediary in making payments or deliveries in connection with securities transactions, providing facilities for trade comparison or compression respecting securities transactions or for the allocation of securities settlement responsibilities, or acting as a securities depository through interstate commerce means can only be performed by a registered clearing agency. *See* Sections 3(a)(23) and 17A(b)(1) of the Exchange Act, 15 U.S.C. 78c(a)(23) and 78q-1(b)(1).