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## SEC Proposes Cybersecurity Rules for Broker-Dealers

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### INTRODUCTION

Last week, the SEC proposed a package of proposals focused on cybersecurity risks [Securities Exchange Act Release No. 97142 (March 15, 2023)]. Among the proposals were a proposed new rule (Rule 10) and new form (Form SCIR) focused on cybersecurity matters for securities market participants, including broker-dealers. Proposed Rule 10 extends to all broker-dealers but imposes additional cybersecurity risk measures on firms that the SEC perceives to be so interconnected and/or large that they pose greater cybersecurity risks and threats to the system should they experience a significant cybersecurity incident. Proposed Rule 10 would require firms to establish and implement policies and procedures reasonably designed to address cybersecurity risks and mediate significant cybersecurity breaches. The proposal would include notice, reporting, and confidential and public disclosure requirements.

### COMMENT PERIOD

The comment period expires June 5, 2023.

### CONTACT

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### SUMMARY OF PROPOSAL FOR BROKER-DEALERS

The recent SEC proposal is intended to reach a broad group of securities market participants that include broker-dealers, clearing agencies, transfer agents, security-based swap dealers, major security-based swap participants, security-based swap data repositories, and self-regulatory organizations that include FINRA, the MSRB, and the 16 national securities exchanges. At the same time, the SEC proposed amendments to Regulation SCI and Regulation S-P, as well as re-opened the comment period for the cybersecurity rule proposals for investment advisers, registered investment companies, and business-development companies, rule proposals pending since February 2022.

Our summary below focuses on the impact of the cybersecurity and proposed expansion of Regulation SCI on the broker-dealer community.

**Reach of Proposed Rule 10.** The following types of broker-dealers are subject to the prescriptive regulations of proposed Rule 10 and corresponding reporting: (i) carrying/clearing broker-dealers (including firms that introduce trades to clearing brokers on an omnibus basis); (ii) introducing broker-dealers that introduce customers to clearing broker-dealers on a fully disclosed basis; (iii) broker-dealers with regulatory capital exceeding \$50 million; (iv) broker-dealers with total assets of \$1 billion or more; (v) market makers; and (vi) broker-dealers that operate an ATS (collectively, “Covered BDs”). Firms that are not Covered BDs (mutual fund firms, small underwriters, and placement agents) are nonetheless responsible for establishing and implementing policies and procedures, but would not be subject to the prescriptive elements of proposed Rule 10, as noted below; nor would they be responsible for internal reporting to the same extent as a Covered BD.

**1. WSPs.** A Covered BD would be responsible for establishing WSPs reasonably designed to address cybersecurity risks to its business. The WSPs would need to incorporate the following prescriptive elements: (i) periodic risk assessment no less frequently than annually of any cybersecurity risks to information systems and documentation of the assessment; (ii) implement controls to minimize user risk and prevent unauthorized access to the firm’s information systems; (iii) take measures to monitor the firm’s information systems and oversight of vendors that receive, maintain, process, and/or access the firm’s information systems; (iv) establish measures to detect, mitigate, and remediate cybersecurity threats and vulnerabilities; and (v) implement a process to detect, respond to, and recover from a significant cybersecurity incident and document the process of detecting, responding to, and recovering from a cybersecurity incident. Other broker-dealers would be responsible for establishing and implementing policies and procedures reasonably designed to address cybersecurity risks commensurate with their business but would not be subject to the prescriptive elements above.

**2. Technical Definitions.** The proposed rule prescribes a set of technical definitions for, among others, “cybersecurity risk,” “cybersecurity vulnerability,” and “significant cybersecurity incident.” These definitions are intended to apply broadly.

**3. Notices of Cybersecurity Event.** The proposal would require immediate electronic notice to the SEC if any broker-dealer experiences a cybersecurity event and immediate reporting to the SEC and designated examining authority of any “significant cybersecurity incident.” Covered BDs would additionally be required to make confidential initial and updating disclosures on Part I of proposed Form SCIR regarding the handling of a “significant cybersecurity incident.”

**4. Disclosure of Cybersecurity Risks and Incidents.** The proposal would require Covered BDs to publicly disclose on Part II of proposed Form SCIR a summary of cybersecurity risks and any significant cybersecurity incidents each year. In addition to filing the proposed Form SCIR with the SEC, a Covered BD will need to post the Part II disclosure on its website. Customers of carrying and introducing brokers would be entitled to the Part II disclosures of Form SCIR at the account-opening stage, upon material updates to Part II, and annually.

**Extending the Reach of Regulation SCI.** Also on March 15, 2023, and in a separate proposal, the SEC proposed to expand the market participants subject to Regulation SCI, a regulation that applies to systems that process securities transactions and is intended to reduce systems outages and improve resiliency in the case of outages or disruptions. This proposal would expand the meaning of “SCI entity” to include broker-dealers that meet or exceed: (i) a total assets threshold, or (ii) one or more transaction activity thresholds. The tests are complex. The tests would be (i) measured, in the case of the asset test, at 5% or more of the total assets of all broker-dealers during two of the preceding calendar quarters; or (ii), for the transaction activity test, based on the daily average trading volume over four of the preceding calendar months, essentially 10% or more of the average trading volume in NMS stocks, exchange-listed options, Treasuries, and agency securities, as reported in specified reporting mediums. According to the SEC, the proposal is intended to capture the largest U.S. firms.

## CONCLUSION

Proposed Rule 10 and proposed Form SCIR were met with a divided vote and the devil will be in the details of the very prescriptive elements of proposed Rule 10 and its technical definitions and the robust reporting disclosures of proposed Form SCIR. We invite thoughts and considerations of how these proposals may impact the operations of the broker-dealer community and if they benefit the intended goal of cybersecurity protection and mitigation of cybersecurity risk.

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