VIRTU FINANCIAL

April 26, 2022

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: Short Position and Short Activity Reporting by Institutional Investment Managers; Release No. 34-94313; File No. S7-08-22 (Feb. 25, 2022); Notice of the Text of the Proposed Amendments to the National Market System Plan Governing the Consolidated Audit Trail for Purposes of Short Sale-related Data Collection; Release No. 34-94314; File No. S7-08-22 (Feb. 25, 2022)**

Dear Ms. Countryman:

Virtu Financial, Inc.[1] ("Virtu") respectfully submits this letter in response to the above-referenced rule proposal issued by the Securities and Exchange Commission (the "SEC" or "Commission") on February 25, 2022 (the "Proposal").[2] While we are supportive of well-reasoned and sensible regulation that ensures fair, honest and transparent markets, we believe this Proposal misses the mark and will result in the reporting of data that is unlikely to meaningfully shed light on short sale activity.

The Proposal would also foist massive, unreasonable costs on firms to update their systems and trading processes in order to comply. Specifically, the Proposal estimates that compliance costs to update systems necessary to capture and report the information required for Proposed Form SHO could be as much as $156,309,500[3] – a staggering number by any measure –and will

[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. Virtu broadly supports innovation and enhancements to transparency and fairness that increase liquidity and promote competition to the benefit of all marketplace participants.

[2] U.S. Securities & Exchange Commission, Proposed Rule: *Short Position and Short Activity Reporting by Institutional Investment Managers*; Release No. 34-94313; File No. S7-08-22 (Feb. 25, 2022), available at https://www.sec.gov/rules/proposed/2022/34-94313.pdf; *Notice of the Text of the Proposed Amendments to the National Market System Plan Governing the Consolidated Audit Trail for Purposes of Short Sale-related Data Collection*; Release No. 34-94314; File No. S7-08-22 (Feb. 25, 2022), available at https://www.sec.gov/rules/proposed/2022/34-94314.pdf.

[3] *Short Position and Short Activity Reporting by Institutional Investment Managers, supra* n. 2, at 136.

further burden firms with ongoing annual compliance costs of up to $52 million.[4] Candidly, we are concerned that the Proposal underestimates the actual costs of compliance and implementation that will be borne by market participants and ultimately passed on to investors.

For context, in a filing submitted last year, the NMS CAT Operating Committee reported that historical costs to build the CAT from 2012 through 2020 – an eight year project undertaken by multiple parties and outside contractors and involving an incredibly complex technology buildout – were $193,273,342.[5] It is beyond perplexing to us that the Commission would propose a rule that would require the industry to report short sale data, much of it redundant of other data that is already required to be reported and that the SEC can already collect on demand from broker-dealers, in a manner that would be almost as costly as eight years of work on the CAT. The sticker shock of the estimated costs is all the more unreasonable given that much of the data the Proposal would seek, such as buy to cover and bona fide market maker exception marking, constitutes "nice to have" information. The Commission has not proffered a regulatory need or justification for why the current reporting regime is inadequate.

The costs to implement the Proposal dramatically outweigh the potential benefits of collecting short sale data, especially because that data would bear little resemblance to reporting entities' actual short positions. As the Commission acknowledges in the Proposal, there are currently multiple sources of both public and non-public data related to short sales. We advocate that the Commission explore ways to utilize the existing sources of data that already are available to the SEC rather than establishing yet another pool of short sale data.

Our views on these specific elements of the Proposal follow.

Proposed Rule 13f-2 and Proposed Form SHO

Under the Proposal, the threshold for reporting is triggered when an "investment manager" (which would include many broker-dealers and potentially many buy-side entities) has established for reporting issuers a gross short position in an equity security with a collective U.S. dollar value of $10 million or more at the close of regular trading hours on any settlement date during the calendar month, or a monthly average gross short position as a percentage of shares outstanding in the equity security of 2.5 percent. For non-reporting issuers, the threshold would be a gross short position in an equity security with a collective U.S. dollar value of $500,000 or more at the close of regular trading hours on any settlement date during the calendar month.

We strongly believe that the dollar value thresholds referenced in the Proposal are significantly lower than is necessary and very likely would pull in market making, hedging, and similar facilitation type positions of higher priced securities where the actual short positions are very low in relation to the number of shares outstanding but would meet the thresholds as proposed

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[4] *Id.* at 137.

[5] *Joint Industry Plan; Notice of Filing of Amendment to the National Market System Plan Governing the Consolidated Audit Trail*, 86 FR 21050; Release No. 34-91555 File No. 4-698; 2021-08049, at p. 56 (April 21, 2021).

because of the dollar value of the security. Moreover, the requirement to report such positions on a gross rather than net basis would likely distort the actual degree of short positions as it will capture circumstances where a firm is net long but may have short positions among its accounts.

We also object to the reporting requirement being triggered by the existence of a short position on any settlement date within a reporting period. Again, we believe that this requirement will result in burdensome reporting requirements as a result of transient short positions that result from market making, hedging, and customer facilitation activity. We would advocate exempting from this requirement these types of transactions.

Finally, we note that the requirement to mark short positions being reported as hedged, partially hedged, or unhedged would be operationally difficult to implement and we advocate for eliminating that aspect of reporting. The reporting the Commission would require would be produced by back-office systems on gross positions. These back-office systems generally do not have any linkage information to allow them to match a hedge to a short position. Thus, new, costly systems would have to be developed to create the necessary linkages between specific financial instruments and the reported short positions. Furthermore, what constitutes a hedge may be subject to interpretation. While firms have existing systems to assess risk based on financial instruments that offset the economic exposure of one another, it is unclear whether these methodologies may be used for Regulation SHO reporting.

Buy to Cover Marking Requirements

Under the current framework of Regulation SHO, broker-dealers must mark sale orders as "long," "short", or "short-exempt", but are not required to mark purchase orders. There is no concept of "buy to cover." Under the Proposal, Regulation SHO would be expanded to require broker-dealers to mark a purchase order as "buy to cover" if the purchase is for an account that already has a gross short position in the same security at the time of the purchase.

If this aspect of the Proposal were adopted, firms would have to reprogram their systems to recognize a buy to cover order. We believe that this would be exceedingly burdensome, costly, and challenging for broker-dealers to make the required changes and provide the required information. As we will discuss below, the current marking requirements have significant flaws and the adding the buy to cover requirement will make the data even more incongruous and will not lead to more transparency about short selling activity.

The Commission's current guidance on sell order marking under Regulation SHO illustrates these flaws. Under Regulation SHO, a broker-dealer is required to mark every sell order as long, short, or short exempt. Historically, orders were marked at the time they were entered based upon a person's or entity's position at that moment in time. The electronification of the markets has made it possible to transmit many sell orders in very short time frames such that several orders might be transmitted but not yet executed, and marked long even if they collectively amounted to more shares that one's long positions – a circumstance the Commission has referred to as "in-flight orders." To address this circumstance, the SEC provided guidance under FAQ 2.5

of the Division's "Responses to Frequently Asked Questions Concerning Regulation SHO,"[6] that essentially requires an assessment of one's actual position plus any open but unexecuted sell orders to determine whether an order could be marked long or short. The Commission determined that all sell orders, including those orders that essentially are a market maker's quotations on the offer side at the best offer and levels above the best offer, must be included when assessing one's position for sell order marking. As a result, market makers, and especially those market makers that maintain a limit order book and reflect customer's limit orders in their quotations, mark virtually all of their sell orders as "short" sales even when the firm's actual position is long.

To illustrate this, assume that a broker-dealer has a 1,000 share long position and posts offers to sell 1,000 shares on multiple markets, or at different price points on the same market. Under FAQ 2.5, the broker-dealer would have to decrement its 1,000 share long position after the first offer is posted, even if such offer has not yet been executed. The broker- dealer therefore would be required to mark each offer posted after the first offer as "short." However, the broker-dealer may not offset its open offers with open bids. This significantly increases the number of orders marked "short". Many of these orders in actuality do not cause the broker-dealer to establish a short position. The effect is even more pronounced for market makers that maintain a customer limit order book because the broker-dealer enters sell orders to reflect the price and size of customer limit orders (which may be orders where the customer is selling long) it holds. Execution of these orders generally result in riskless principal executions that do not cause any change in the market maker's position.

In connection with a prior no-action request, a predecessor entity of Virtu analyzed certain activity on a sample trading day to compare the accuracy of marking offers consistent with the guidance of FAQ 2.5 against the accuracy of marking offers based on the firm's position, as updated upon execution of an offer that is posted as part of the firm's trading activity. That analysis showed that marking based on the firm's position, as updated upon executions, was far more accurate than marking based on the guidance of FAQ 2.5. Specifically, the analysis concluded that for 25 symbols with the most sell executions on a certain trading day, there was a greater percentage of mismarked offers at the time of offer submission (*i.e.*, the marking of the offer did not match the firm's actual realized position at the time of offer submission) under the FAQ 2.5 approach. The sample data that was provided to the SEC is reflective of the firm's marking in virtually all securities every day.[7] Nonetheless, our firm and every other firm had to develop systems to allow for the marking or orders as sell short based upon the FAQ 2.5 Guidance.

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[6] U.S. Securities and Exchange Commission, Division of Trading and Markets, *Responses to Frequently Asked Questions Concerning Regulation SHO* (Oct. 15, 2015), *available at* https://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.

[7] The sample data provided to the SEC at that time was for a market making desk that did not handle customer orders. For desks that handle customer orders and reflect non-marketable limit orders in their proprietary quotes the degree of inaccuracy is magnified to the point that the vast majority of sell orders placed are marked as sell short even when the firm's position is long.

Now the SEC is proposing marking of certain buy orders as "buy to cover" using a different but equally challenging framework. These "buy to cover" orders would have very little relationship to sell orders marked sell short. Firms would have to develop other systems to mark orders buy to cover and report them to CAT. It is unclear how firms would determine when a buy order was entered to cover a short position, and it is easy to see the same "in-flight order" issues recurring with buy to cover marking. Ultimately, what the Commission would receive is flawed data that would be unlikely to provide any more transparency into short selling activities and that would be very costly for firms to implement operationally and costly to maintain.

Bona Fide Market Maker Activity Exception Reporting to CAT

Equally problematic is the newly proposed Sections 6.4(d)(ii)(E) of the CAT NMS Plan requiring that an order to sell an equity security be marked as a short sale effected in reliance on the bona-fide market making activities exception to the locate requirement under Rule 203(b)(2)(iii) of Regulation SHO. As with the buy to cover requirement, mandating that a market maker report every transaction to CAT where the market maker is relying on the bona fide market maker exception would be costly to operationalize in a manner that is compliant with the rule.

Moreover, similar to the buy to cover requirement, the Proposal's requirement to mark orders as bona fide marking activities would yield data that bears little to no relationship to a firm's actual short position. In practice, market makers are compelled to mark virtually all orders as short sales effected because of the "in flight order" scenario described above. Thus, if this aspect of the Proposal were adopted, market makers would be reporting to CAT transactions that, because of the Commissions FAQ 2.5 interpretation, are not truly short sales but nonetheless would have to be reported as short sales for which the market maker is relying on the bona fide market making exception. If the Commission's objective is to increase transparency, this provision is counterproductive because it would result in the reporting of data that will often be based solely an order marked "sell short" that does not accurately reflect what a firm's actual short position is.[8]

The Proposal Fails to Identify Market Failure that Needs to be Addressed

What's more, the Commission has failed to meet its burden to show that there is a market failure that needs to be addressed with respect to order marking as buy to cover or the bona fide market maker exception. When promulgating rules under the Securities Exchange Act, the Commission is required to conduct an economic analysis of the likely consequences of a rule. The Securities Exchange Act provides that the Commission must always consider "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

[8] If the Commission's real objective is to increase transparency on short selling activities, we would also strongly suggest that the Commission revisit its FAQ 2.5 interpretation and go back to an order marking framework that involves marking orders in a manner that is closer in fidelity to a firm's actual short positions rather than the current framework that simply provides significantly flawed order marking data. While firms have likely collectively spent tens of millions of dollars (or more) creating systems to mark orders that bear no resemblance to their true short positions, not having to maintain these systems and incur ongoing costs would still be a better alternative.

of" the securities laws. 15 U.S.C. § 78w(a)(2). In addition, in connection with facilitating the establishment of a national market system for securities, the SEC is expressly required to have "due regard for the public interest" and the "protection of investors." 15 U.S.C. § 78k-1(a)(2). In considering the "public interest," the Commission must also consider, "whether the action will promote efficiency, competition and capital formation." 15 U.S.C. § 78c(f). Courts have held that, in considering the impact of a rule on efficiency, competition and capital formation, the Commission has a "statutory responsibility to determine the likely economic consequences of a rule." *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); see also *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005).

In 2012, the Commission's Division of Risk, Strategy, and Financial Innovation – now known as the Division of Economic and Risk Analysis – and the Office of the General Counsel issued guidance on economic analysis in Commission rulemakings.[9] Among other items, the guidance provides that each rulemaking include a sound economic analysis with the following element: "a statement of the need for the proposed action."

In the current Proposal, the Commission's stated rationale for requiring reporting of bona fide market making activity to CAT is that it would provide an additional tool to determine whether such activity qualifies for the bona fide market making exception or, "could be indicative of, for example, proprietary trading instead of bona-fide market making." However, the SEC already has authority to request such information from broker-dealers "on demand" to determine which short sale orders have been submitted pursuant to such exception. The Proposal offers no data or evidence that its access to data about the use of the exception has been limited in any way under the current process it uses to collect such information from broker-dealers, nor that there are widespread violations or other abuses of the exception that warrant imposing substantial costs and burdens on market makers also to report this information to CAT. The Proposal's rationale for requiring broker-dealers to mark transactions a buy to cover – *i.e.* to facilitate the identification of potential "short squeeze" activity – is equally unpersuasive. As described above, the data that will be reported under this provision will bear little resemblance to a firm's actual short sale positions and therefore will not yield meaningful information that would allow the Commission to targe short squeeze activity.

For the reasons articulated above, Virtu recommends that that the SEC eliminate the proposed amendments to the CAT NMS Plan from the Proposal in their entirety.

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[9] Current Guidance on Economic Analysis in SEC Rulemakings (Mar. 16, 2012), *available at* http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

Virtu appreciates the opportunity to comment on the Proposal. Our firm 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. While we support many of the Proposal's recommended enhancements to the rules governing short sales that are narrowly tailored and focused on greater transparency, the new "buy to cover" marking requirements and CAT reporting of market maker exception activity are far from narrowly tailored and will impose substantial costs on market participants (that ultimately will be borne by investors) without the requisite corresponding benefits or articulation of a market failure that warrants a rule change.

Respectfully submitted,

Thomas M. Merritt
Deputy General Counsel

cc: The Honorable Gary Gensler, Chair
The Honorable Hester M. Peirce, Commissioner
The Honorable Allison H. Lee, Commissioner
The Honorable Caroline A. Crenshaw, Commissioner
Dr. Haoxiang Zhu, Director, Division of Trading and Markets