Response to SEC Questions Regarding the List of Rules to be Reviewed Pursuant to the Regulatory Flexibility Act, File Number S7-21-16

We recognize this SEC request for comment is for a review of Regulation NMS and its' affect on small entities under the Regulatory Flexibility Act. However, we are using this comment period as an opportunity to provide a brief overview for consideration of a more holistic review of Regulation NMS and its' effect on the U.S. equity markets.

We believe a review of Regulation NMS and the U.S. equity market structure should be undertaken and consider, at the least, all of the relevant market factors and systems discussed below:

- There are ongoing, high levels of short selling being executed across Self Regulatory Organizations ("SROs") in important U.S. publicly traded companies and exchange traded products. Short selling can be used to manipulate securities and markets, raise leverage throughout the capital markets to dangerous levels and increase the extent of activity in violation of federal securities laws (including customer protection rules). There are only two types of sales in the general securities marketplace; long (owned by the sellers) and short (not owned by the sellers). The data indicates that since the 2008 financial crisis, the second type of selling (short) has become very extensive. Regulation NMS allowed the creation of many additional trade venues, including Alternative Trading Systems ("ATSs")/dark pools that do not report short sales by security. For transparency purposes, it is important that all venues in the National Market System (SROs and other trading venues) report short sale data daily to regulators and the public, as most SROs do today. The availability of this information could help to shed light on these under-regulated, opaque trading venues that now make up a third or more of the trading in some securities.
- The industry has stated that ATSs are a tool for institutions to trade large blocks of shares discreetly and avoid predatory trading strategies designed against institutional traders. However, the data shows most ATSs have a trade size averaging between 100 and 200 shares (far less than a block trade), which brings into question the value that ATSs/dark pools add to the marketplace. If the purpose of ATSs is to hide trades from the rest of the market, not disclose legitimate bids/asks or to internalize trades for the benefit of the dark pool operators as contra parties, then the value of their very existence is debatable. In considering market structure, we do not think this was the expected outcome/goals when the SEC approved Regulation NMS.
- False locates are being provided on a large-scale for what could be unbridled illegal short selling (locates are affirmative determinations shares are available and there is an intent by the clearing firm to borrow/legitimately supply the shares to complete legal settlement of a short sale). As we have previously stated,[1] a system referred to as 'hard locates' would be the effective way to curtail this dangerous activity. The share availability data is currently distributed in the morning by firms that have shares available to loan for short sales. At the present, there are no intraday share lending controls across the markets and no central repository for availability information. All shares available to be loaned should be uploaded into one central securities lending database with the lending party identified. Throughout the trading day, the data would be updated in real-time; shares that are committed for delivery of

[1] *Response to SEC Questions Regarding the CAT File Number 4-698 071816*, dated July 18, 2016 https://www.sec.gov/comments/4-698/4698-12.pdf

short sales or otherwise should reduce the number of available securities and new availability of securities coming into the lending market should be added to the database by the lending party (a running inventory of share lending and borrowing). The database should also include internal broker-dealer inventory that is available for lending, regardless of whether the inventory is available for external or internal (designated as such) borrowing from a firm.

- All data (including FOCUS Reports, Financial Stability Oversight Council Annual Reports,[2] short sales versus reported short interest and the joint working paper between the Office of Financial Research, Federal Reserve and the SEC[3]) indicates the lending markets are not being adequately used by clearing firms to support the short selling (some appear to be profiting from not borrowing). High levels of short selling without share lending (described as naked short selling by the SEC) disrupts the natural supply/demand in the lending market that normally constrains short selling through costs to borrow and supply availability. A properly functioning lending market adds to a more true and accurate price discovery and is very important to the operations and natural functioning of the U.S. capital markets. Short sales with unlimited supplies of synthetic securities borne from sham transactions do not contribute to the underlying fundamentals of the economic system, which; a) cause inaccurate reporting to the marketplace, investors and regulators, and b) raise the probability of systemic risk from over-leveraging, which impedes assets segregated under consumer protection regulations and the fundamental underlying net capital that supports a firm's financial stability.

- Ex-cleared transactions (trades not sent to the national clearance and settlement system, including pre-netted, compressed, summarized and internalized trades) have become a detrimental loophole in the national clearance and settlement system that can affect the real net capital of a firm (causing inaccurate reporting) and/or the segregation of securities for the protection of investors. The mounting number and value of ex-cleared trades could produce systemic risk for the settlement system, which is advertised to be the central counterparty to transactional activity in the U.S. securities markets. When Regulation NMS was adopted, the SEC and market observers did not recognize ex-clearing as a significant loophole. In the original crafting of Regulation SHO (implemented in 2005), the industry told the SEC that ex-cleared trades were "rare".[4] The SEC determined that NSCC data would be an accurate measurement of fails in the clearance and settlement system that would red flag the SEC of abusive/illegal short selling behavior and therefore ex-clearing was excluded from Regulation SHO. This NSCC/CNS ex-clearing trade reporting loophole/problem appears to have developed significantly after the implementations of Regulation SHO and Rule 204-T (a

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[2] For example, see Financial Stability Oversight Council 2014 Annual Report and Annual Report Data http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2014-Annual-Report.aspx

[3] Office of Financial Research joint working paper with the Federal Reserve Board of Governors, Federal Reserve Bank of New York and the SEC titled *A Pilot Survey of Agent Securities Lending Activity,* August 2016 https://www.sec.gov/dera/staff-papers/white-papers/Porter_PilotSurveyAgentSecuritiesLendingActivity.pdf

[4] The SEC stated it would revisit its ex-clearing decision if ex-clearing was found not to be rare; it no longer appears to be rare and this loophole should be closed. Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO, Question 5.3: Does the close-out requirement apply to delivery failures that do not occur at a registered clearing agency? Answer: We interpret the close-out requirement to apply only to fail to deliver positions at a registered clearing agency. Our interpretation is based on our understanding that transactions conducted outside the Continuous Net Settlement System ("CNS") operated by the National Securities Clearing Corporation ("NSCC") are ***rare***. If this historical pattern changes and a significant level of fails are not included in CNS, we will reconsider this position. http://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm

NSCC fails closeout rule, October 2008). Clearing outside of the national clearance and settlement system increased further with the growth of high frequency trading/trade compression/internalization, unscrupulous market access provided by some clearing firms and multiple non-exchange trading venues. The ex-clearing loophole and the true extent of delivery failures (which become undisclosed liabilities and operational risks) are flaws within the clearance and settlement system that ultimately could create substantial systemic risk throughout the financial system, threatening the actual day-to-day function of the U.S. markets themselves.

- Whether intentional or not, the outcome of the high levels of trade volume appears to be large-scale washing/matching of trades in some important U.S. securities (resulting in little change in actual beneficial ownership of shares). Washed/matched trading produces an illusion of high intensity demand in the marketplace that does not actually exist. When three of every four shares are sold short (as is the case for some securities), logical math suggests short sellers are trading with other short sellers. In other words, they are buying and selling shares that neither party owns (i.e. thin air). For example, the SPDR S&P Retail ETF (Symbol: XRT) has been sold short for the last 5 years at an average of 69% of the trade volume on reporting markets, while institutional owners alone have continued to report multiple ownership claims of shares issued by the XRT. This volume of short sales cannot be covered with a matching long sale, so it appears that excessive short selling is being 'covered' by round-trip type trading of additional short selling, which again adds the illusion of real activity between buyers and sellers that may not exist.
- When the SEC approved Regulation NMS, it surmised the rules would likely cause increased computerized trading. This result occurred and caused additional abusive pre-market trading that was not anticipated during the crafting of the regulation. The data shows there is a distortion from an unprecedented level of orders placed and cancelled (billions of dollars worth per day for some important securities) that clearly impact price discovery and the appearance of actual interest in the pre-execution market. When this level of orders and cancels are used as a trading strategy (known as layering/spoofing type trading activity), it causes the dissemination of false information into the marketplace and creates a false sense of supply and demand for securities, which is manipulative and damaging to investors and the capital markets.
- Sponsored market access has allowed some market participants that are not market makers to avoid actual market maker registration and circumvent securities regulations. There is no benefit to the public interest to have non-market making firms concealed behind a sponsored access agreement. It is just the opposite; it is against the public interest and regulatory efficiency. Some of the problematic sponsored access activity has been coming from offshore jurisdictions where manipulative trading has been executed through U.S. clearing firms. Some of these offshore participants using sponsored access through U.S. clearing firms have flooded the markets with illegal orders, at times overwhelming other market participants'

trading activity.[5] These types of manipulative acts could seriously undermine the integrity of the U.S capital markets. Sponsored access appears to be a cyber threat loophole that would be easy to close for the protection of the U.S. financial system. If the practice is not eliminated entirely, which it should be, at the least clearing firms supplying such access should be closely monitored with heightened scrutiny and oversight responsibilities.

The U.S. markets have changed considerably since the implementation of Regulation NMS in 2005. The reality of the current marketplace is that real demand has been falling, short selling has skyrocketed, shares borrowed have been decreasing, internalization (shares executed not through the marketplace, but within the clearing firms) appears to have increased significantly and NSCC fails are no longer a relevant metric in the trading of U.S. securities, i.e. the data suggests a lack of real settlement has become the unintended outcome of current regulation along with distorted prices and appearances of demand. We believe a comprehensive, holistic review of Regulation NMS and the current U.S. market structure should include at least the important market mechanisms, strategies and resulting effects discussed above.

[5] *FINRA Charges Wedbush Securities for Systemic Market Access Violations, Anti-Money Laundering and Supervisory Deficiencies*, August 18, 2014 http://www.finra.org/newsroom/newsreleases/2014/p578458
In FINRA's August 2014 press release announcing its action against Wedbush, FINRA stated: "The complaint alleges that from **January 2008 through August 2013**, Wedbush failed to dedicate sufficient resources to ensure appropriate risk management controls and supervisory systems and procedures. This enabled its market access customers to ***flood U.S. exchanges with thousands of potentially manipulative wash trades and other potentially manipulative trades, including manipulative layering and spoofing***."
See also SEC Administrative Proceeding No. 3-15913 *In the Matter of Wedbush Securities, Jeffrey Bell and Christina Fillhart*, June 6, 2014 http://www.sec.gov/litigation/admin/2014/34-72340.pdf