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VIRTU FINANCIAL

January 3, 2018
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street NW
Washington, DC 20006-1506

Re: Regulatory Notice 17-41

Dear Ms. Mitchell:

Virtu Financial Inc. ("Virtu" or "we") is pleased to submit this letter in response to Financial Industry Regulatory Authority ("FINRA") Regulatory Notice 17-41 requesting comment on the effectiveness and efficiency of FINRA Rule 5250 (Payments for Market Making).

We greatly appreciate FINRA's efforts to undertake a broad retrospective review of its rules and to assess their continuing effectiveness. For the reasons discussed in greater detail below, we consider it particularly appropriate for FINRA to revisit and develop modifications to existing Rule 5250 in light of the ongoing evolution of the U.S. securities markets.

Background

Virtu is a leading technology-enabled market maker and liquidity provider to the global financial markets. Virtu operates as a market maker across numerous exchanges in the U.S. and is a member of all U.S. registered stock exchanges and is a Designated Market Maker on the floor of the New York Stock Exchange.

Virtu provides liquidity in more than 19,000 instruments on more than 235 venues and market places, and seeks to provide liquidity across all liquid instruments traded on transparent electronic markets globally. As such, it broadly supports innovation and enhancements to transparency and fairness which enhance liquidity to the benefit of all marketplace participants.

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Reassessment and Modification of Rule 5250

The U.S. equity markets continue to be among the most robust, transparent, and fair markets in the world, and their ongoing development and efforts at modernization significantly benefit from initiatives to continuously improve regulatory requirements, as FINRA has undertaken in Regulatory Notice 17-41. The growth and evolution of markets for exchange-traded products ("ETPs") has played a particularly significant role in expanding opportunities for investors, as well as in fostering diverse capital markets and encouraging healthy marketplace competition. Market making firms have contributed significantly to the growth of these products by ensuring accurate price tracking and providing critical liquidity and price discovery through the commitment of their own capital.

As currently structured, Rule 5250 affords only limited opportunities, through exchange-administered programs, for issuers and sponsors of ETPs and other securities to offer payments or other incentives to broker-dealers willing to offer market making services. In our view, the constraints contained in current Rule 5250 unduly limit potentially beneficial opportunities to promote market making activity that could enhance liquidity, transparency, competitiveness, and capital market resiliency and evolution.

We believe that Rule 5250 can be improved for the benefit of investors and other market participants by modifying the existing Rule to permit direct payments to ETP market makers outside the context of exchange-administered programs. This modification would expand potential competition among ETP sponsors and issuers through increased liquidity for new and innovative products. It would do so, moreover, in a manner that would allow issuers and sponsors of ETPs to tailor incentives more directly to the products most in need of enhanced market making services – in particular new ETPs whose successful launch, in competition with instruments that are already widely traded, depends on the availability of market makers with adequate reason and risk appetite to undertake the necessary commitment of time and capital. Properly implemented, it would also continue to provide investors with the protections necessary to mitigate the potential conflicts of interest that the rule was initially adopted to address.

ETP Markets and the Importance of Market Makers

ETPs have become increasingly important in today's capital markets; over the past decade, the number of ETPs has risen from approximately 600 to over 2,100, with a corresponding increase in market capitalization. During 2016, ETPs represented approximately 23% of U.S. equity trading by share volume and 30% of U.S. equity trading by dollar volume.[1] ETPs have also seen rapid growth in the diversity of strategies pursued by ETP issuers and have opened previously difficult-to-access markets and products to a wider range of investors, including retail investors.[2] The ETP market is also highly concentrated, with market share by assets under management dominated by the top three ETP sponsors.[3]

As a result, liquidity in the ETP market is crucial to the effective functioning of both the ETP market and the broader U.S. equity markets.[4] Effective operation of the ETP markets, and the ability of new and smaller ETP issuers and sponsors to compete, accordingly depends critically on market maker participation. Market makers provide liquidity that promotes efficient pricing, both by generating opportunities for investors to buy and sell securities and by facilitating the creation and redemption of ETP securities prerequisite to the markets' functioning.[5] Ensuring that market makers perform these functions by regularly publishing competitive quotations and maintaining liquidity redounds to the benefit of sponsors and issuers, by enhancing the quality of the market for

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1 *See* Financial Times, *ETFs are eating the US stock market*, January 24, 2017, *available at* https://www.ft.com/content/6dabad28-e19c-11e6-9645-c9357a75844a.

2 *See* U.S. Securities and Exchange Commission, Request for Comment on Exchange-Traded Products, June 12, 2015, *available at* https://www.sec.gov/rules/other/2015/34-75165.pdf.

3 *See* ETF.com, ETF League Table As Of Dec. 5, 2017, *available at* http://www.etf.com/sections/etf-league-tables/etf-league-table-2017-12-05.

4 *See, e.g.*, U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, The Determinants of ETF Trading Pauses on August 24th, 2015, February 2016, *available at* https://www.sec.gov/marketstructure/research/determinants_eft_trading_pauses.pdf (concluding that, in connection with price volatility experienced by the U.S. equity markets on August 24, 2015, ETFs with the highest turnover (daily share volume/shares outstanding) were 3 times less likely to experience a trading pause than those with the lowest).

5 *See supra* note 2 ("Because of the creation and redemption mechanisms, most existing ETPs present market participants, including Authorized Participants, market makers, and institutional investors, with opportunities to engage in arbitrage, which generally helps to prevent the market price of ETP Securities from diverging significantly from the value of the ETP's underlying or reference assets.").

their securities and increasing their competitiveness, and investors, through greater liquidity and lower transaction costs.

FINRA Rule 5250's Exception for ETP Market Maker Incentive Programs

As noted in Regulatory Notice 17-41, Rule 5250's restrictions on payments by issuers and promoters to market makers arose out of concerns focused principally on the potential undisclosed conflicts of interests that these payments might generate, which could mislead investors about the bona fide nature of quotations and prices.[6] FINRA has, however, recognized that payments to market makers may enhance liquidity and improve the market for certain securities under the right circumstances and with appropriate protections in place. Most significantly, in 2013, FINRA amended Rule 5250 to permit payments pursuant to exchanges' programs designed to incentivize market makers quoting in ETP securities.[7]

Market maker incentive programs are designed to enhance the quality of the ETP market in terms of quoted spreads and liquidity by allowing for payments from ETP sponsors and issuers to be directed to market makers in the ETP shares on a periodic basis through an exchange.[8] In

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[6] *See* Notice to Members 96-83, December 1996, *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=1747 ("[S]uch payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.); Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to FINRA Rule 5250 (Payments for Market Making), SR-FINRA-2013-020, April 18, 2013, *available at* https://www.finra.org/sites/default/files/RuleFiling/p248390.pdf ("[T]he existence of undisclosed, private arrangements between market makers and an issuer and/or its promoters may make it difficult for investors to ascertain the true market for the securities, such that what might appear to be independent trading activity may well be illusory.").

[7] *See* Notice of Filing and Immediate Effectiveness of a Proposed Rule Change Relating to FINRA Rule 5250 (Payments for Market Making), SR-FINRA-2013-020, April 18, 2013, *available at* https://www.finra.org/sites/default/files/RuleFiling/p248390.pdf.

[8] *See, e.g.,* Order Granting Approval of a Proposed Rule Change, as Modified by Amendments Nos. 1 and 3 Thereto, to Establish the Market Quality Program, SR-NASDAQ-2012-137, March 20, 2013, *available at* https://www.sec.gov/rules/sro/nasdaq/2013/34-69195.pdf ("[W]ith respect to the monthly quoting requirement, an MQP Market Maker must quote at least 500 shares of attributable, displayed liquidity at the NBB or NBO 25% of the time during the Regular Market Session, and at least 2,500 shares of attributable, displayed liquidity within 2% of the NBB or NBO 90% of the time during the Regular Market Session.").

approving these incentive programs, the U.S. Securities and Exchange Commission ("SEC") recognized that the potential benefits of such payments include enhanced liquidity, narrower spreads, reduced transaction costs, and a more-efficient and less-uncertain trading environment. In addition, these programs may enhance competition among ETP issuers by improving liquidity for new and low-volume ETPs.[9]

The incentive structure of existing exchange-intermediated programs, however, has limited their success in promoting liquidity in new ETPs. In particular, because these programs largely reward market makers based on trading volume – which for new ETPs is necessarily lower – they offer less incentive for market makers to quote those new ETPs. In some cases, there have been efforts to address this issue by bundling Lead Market Maker ("LMM") assignments of the most active ETPs with LMM assignments in new or less liquid ETPs. Even where implemented, however, this bundling does not fully achieve the benefits that would result from allowing direct payments under the Rule and is only available to ETP issuers with active ETPs to bundle with new or less liquid ETPs.[10]

Direct and transparent payments to market makers could enhance competition and efficiency by permitting all ETP issuers and sponsors to target incentives to those new or less active ETPs that would most benefit from greater market liquidity (i.e., by more directly aligning incentives with beneficial market making services). It would do so, moreover, in a manner that could also offer increased rewards for – and attract additional competition from – market makers who might not otherwise be willing to provide the needed liquidity.

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9 *See id.*

10 Notably, the incentives created by bundling of LMM assignments are not as transparent as those that would result from disclosed, direct payments. Further, in practice, bundling can only be used in cases where an existing ETP issuer already has a number of actively traded ETPs available to be "bundled" with new products – thereby limiting the ability of newer or smaller ETP issuers (who do not have active ETPs available for "bundling") to utilize this strategy to promote their products. In addition, because the aggregate amount of LMM incentives is primarily driven by the trading volume of the most active ETPs, the "bundling" of new or less-active ETPs with more active instruments dilutes the aggregate incentives for each "bundle" of LMM assignments made to an LMM and, correspondingly, dilutes incentives for additional market makers to participate in the programs.

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In its previous amendment to Rule 5250 that allowed for such programs, FINRA stated that the transparency created by disclosure under those programs mitigated potential concerns regarding "illusory" markets that might arise in the context of undisclosed payments. FINRA also noted that these important disclosures would allow investors to determine which exchange-traded funds are and are not subject to the program.[11]

Direct Payments to ETP Market Makers Under Rule 5250

The ETP market would, in our view, greatly benefit from extending the existing exception for exchange-administered programs to allow for direct payments from ETP sponsors and issuers to market markers, subject to appropriate disclosure requirements designed to mitigate potential conflicts of interest.

Direct payments would, as noted above, enhance ETP markets by advancing objectives recognized by the SEC – including improved liquidity, reduced transaction costs, and increased competition – by providing an efficient means for new sponsors and issuers to enter the market and support their products. Indeed, direct payments to market makers without the intervention of exchanges are likely to achieve these goals more effectively by enabling issuers to target payments to those instruments where market maker liquidity would add the greatest value and thereby promote needed competition in markets for ETPs. Direct payments would also be more efficient, as the payments can be made, in appropriate cases, without the need for an exchange intermediary.

Accordingly, we strongly encourage FINRA to take steps, either under existing Rule 5250 or through revision of the Rule as occurred in 2013, that would enable ETP issuers and sponsors to make direct payments to market makers outside of the context of an exchange-administered incentive program in a manner consistent with advancing liquidity, transparency, and competition in the ETP market while ensuring the protection of investors.

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[11] *See supra* note 7 ("FINRA also believes the NASDAQ MQP contains several features that mitigate the concerns [regarding payments to market makers]. For example, the terms of the NASDAQ MQP generally are 'objective, clear, and transparent' and includes [sic] disclosure requirements to help alert and educate potential and existing investors about the program.").

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Once again, we appreciate the opportunity to share our views on this important issue and would be pleased to discuss in further detail as and when appropriate. If you have any questions, please do not hesitate to contact Thomas M. Merritt, Deputy General Counsel.

Yours Sincerely,

Douglas A. Cifu
Chief Executive Officer
Virtu Financial