OTC Markets

December 3, 2021

Via Email Submission (pubcom@finra.org)

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

> **Re: *Regulatory Notice 21-19 – FINRA Requests Comment on Short Interest Position Reporting Enhancements and Other Changes Related to Short Sale Reporting***

Dear Ms. Mitchell,

OTC Markets Group Inc. ("OTC Markets Group")[1] respectfully submits this letter in response to the request for comment by the Financial Industry Regulatory Authority, Inc. ("FINRA") in Regulatory Notice 21-19 concerning enhancements to FINRA's short sale reporting rules (the "RN").[2]

Over 15 years after the Security and Exchange Commission's ("SEC") adoption of Regulation SHO, short selling activity remains a controversial practice and highly debated topic. Investor frustration stemming from perceived short selling abuses and misconceptions around market making has recently generated a surge of activity in online forums.[3] Much of that investor angst is a result of how short selling data is reported and published.

Short selling is vital to efficient pricing and liquidity. However, without adequate transparency and regulatory oversight, it can be used to facilitate illegal market manipulation.[4] As a market operator dedicated to creating better informed, more efficient financial markets, we believe FINRA must first examine how current short selling data is used and misused today before exploring how it can be improved and enhanced. A

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[1] OTC Markets Group Inc. operates the OTCQX® Best Market, the OTCQB® Venture Market and the Pink® Open Market for over 11,000 U.S. and global securities. Through our OTC Link® Alternative Trading Systems, we connect a diverse network of broker-dealers that provide liquidity and execution services. We enable investors to easily trade through the broker of their choice and empower companies to improve the quality of information available for investors. OTC Link ATS, OTC Link ECN and OTC Link NQB are each SEC regulated ATSs, operated by OTC Link LLC, member FINRA/SIPC.

[2] FINRA Regulatory Notice 21-19 (June 4, 2021), available at: https://www.finra.org/sites/default/files/2021-06/Regulatory-Notice-21-19.pdf.

[3] *See e.g.* Wall Street Journal, "The GameStop Short Squeeze Shows an Ugly Side of the Investing World," (Jan. 27, 2021), available at: https://www.wsj.com/articles/gamestop-stock-short-squeeze-ugly-side-11611750250 ("In the past week, there has been an uptick in references to well-known short sellers like Mr. Left and Muddy Waters LLC's Carson Block on Reddit channels, blogs and other social-media venues, according to a review by Meltwater, a global media intelligence company."). One needs only to follow #nakedshorting on Twitter to experience the investor frustration and confusion firsthand.

[4] Manipulative shorting activity dates back over two decades. *See e.g.* Wall Street Journal, "Regulators Expel, Fine Fiero For Fraudulent Short Selling," (Jan. 9, 2001), available at: https://www.wsj.com/articles/SB978981972173206802 ("In recent years, public company officials have contended that market makers misuse naked shorting to manipulate down the price of stocks.").

thoughtful regulatory framework can help address investor misunderstandings and incentivize market maker liquidity provision.

Above all, FINRA should prioritize reliable short sale data as part of the overall "***good" market data*****:** data that allows member firms to deliver best execution; data that allows investors to analyze supply and demand; data to identify manipulation and regulate market participants; and data that can be effectively anonymized and aggregated. Better short selling data is vital to building trust in our markets.

Understanding Short Sale Activity

The fundamental problems with the short sale data available today, and the resultant investor confusion, stem from a general misunderstanding of how different market participants engage in short selling. The SEC has described the practice as follows:

> Short selling involves the sale of a stock that the seller does not own [and] is typically done: (1) when a person expects a stock to decline and borrows the stock from someone else to sell it at a current high price and later "cover" the sale by purchasing it at a lower price to give back to the lender; (2) by a market maker selling to a customer that wants to buy at a time when the firm does not have enough of the stock in its inventory to fill the customer's order; or (3) to hedge (*i.e.*, reduce the economic exposure of) a long position in the same or a related security.[5]

Short selling can be grouped into two types of market activity—portfolio positions (directional) and intraday covers by firms engaged in bona fide market making activity[6] (temporal):

> Directional Short Sales: Scenarios (1) and (3) above each represent the traditional investor short position: betting against the ultimate success of the company, whether as part of a hedging strategy or for potential upside.[7]

> Temporal Short Sales: Scenario (2) represents an entirely different motivation for short selling: rather than betting against the long-term success of the company, market makers and liquidity providers sell stocks short to fill a customer order, then immediately purchase the shares (within seconds or minutes). This practice of selling and buying to provide temporal liquidity facilitates efficient trade executions for investors. Market maker short selling only becomes directional, as a bet against a company or as part of a hedging strategy, if the firm maintains a

[5] SEC Staff Report on Equity and Options Market Structure Conditions in Early 2021 (Oct. 14, 2021), available at: https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf.
[6] The terms "bona fide market making activity" and "bona fide market maker" are used herein in reference to the activity contemplated under Rule 203(b)(2)(iii) and Rule 204(a)(3) of Regulation SHO. 17 CFR §§ 242.203(b)(2)(iii), 242.204(a)(3).
[7] *See* supra note 3 ("Short sellers are fringe players who go after companies and institutions the rest of the financial world is largely backing. They often make bets based on deep research, sometimes exposing fraud. Recent successes include firms like Nikola Corp., Wirecard AG and Valeant Pharmaceuticals International Inc.").

net short position at the end of the trading day.

As set forth below, FINRA's short sale reporting regime should not lump all short sale activity together, but instead should treat temporal market marker liquidity differently than longer-term, directional short positions. Separating these different activities will enhance regulatory oversight and improve investor understanding.

The Good Data—FINRA Equity Short Interest

The most reliable insight into directional shorting activity in a particular OTC security is the aggregate short position data that firms provide to FINRA on a twice-monthly basis under Rule 4560. This information reflects the total number of shares held short in the security and can be compared to total shares outstanding to provide a view into the overall short interest.

Aggregate position information reported under Rule 4560 is reported post-settlement and is part of clearing firms' books and records, generally making it of high quality. FINRA can enhance the value of this data by collecting it daily and making the daily data available on a delayed basis. This data should be further segregated by (i) short positions in bona fide market making accounts, and (ii) all other short positions reported under Rule 4560.[8]

The Bad Data—FINRA Daily Short Sale Volume Data

FINRA's daily short sale volume data is misleading and widely misinterpreted because it includes both directional and temporal short selling activity. The problem is due to how market makers provide liquidity, as well as SEC guidance concerning short sale marking requirements.[9]

This daily file is composed of all media-reported (*i.e.* published) short sale trades and is intended to reflect the aggregate volume of trades executed and reported as short sales on each trade date. This method of collection causes the aggregate volume output to appear to reflect a higher concentration of directional short sale activity than is actually occurring. In looking at the volume data, investors see the large amount of market maker short sales, but not the equally large number of buys made by bona fide market makers. This makes directional short selling information nearly impossible to discern in securities with active market making.

We first raised these issues in November 2018.[10] FINRA has since acknowledged the

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[8] Identifying bona fide market maker short positions would allow the SEC to consider extended delivery times for Reg SHO close outs.
[9] *See* SEC, Division of Market Regulation, "Responses to Frequently Asked Questions Concerning Regulation SHO", available at: https://www.sec.gov/divisions/marketreg/mrfaqregsho1204.htm.
[10] *See* OTC Markets Group Blog, "Understanding Short Sale Activity" (Nov. 13, 2018), available at: https://blog.otcmarkets.com/2018/11/13/understanding-short-sale-activity/. ("The daily short selling volume is misleading because market makers and principal trading firms report a large number of trades as short sales in positions that they quickly cover. For market makers with a customer order to sell, they will temporarily sell short (which gets published to the tape as a media transaction for public dissemination) and then immediately buy from their customer in a non-media transaction that is not publicly disseminated to avoid double counting share volumes. SEC guidance also mandates that almost all principal trading firms that provide liquidity at multiple price levels, or arbitrage international securities, must mark orders they enter as short, even though those firms might also have strategies that tend to flatten by end of day.").

widespread industry confusion, issuing a 2019 notice describing the problem as threefold: (1) non-media reportable buying activity that might offset the total daily short sale volume is not included in the file; (2) the data is not consolidated, but rather spread across multiple reporting venues and exchanges; and (3) market participants often mistake the data for total short sale positions, rather than transactional volume.[11]

While FINRA's 2019 notice helped acknowledge and clarify the problem, it did not solve it. ***Comingling directional short selling with temporal market making sales artificially inflates the aggregate short sale volume to such an extent that it is no longer useful or reliable***. This daily volume data is also economically misleading. If a market maker has an underlying customer or correspondent order that is immediately executable, the short sale is transitory: it is a temporal market making sale that has little to no impact the firm's end-of-day position. For these reasons, we do not display daily short sale volume on our website.

FINRA's market regulation and transparency function would be much better served if it tracked all bona fide market maker purchases and sales on a firm-by-firm basis and reported the net change on a day-to-day basis. In its capacity as an SRO industry regulator, FINRA would benefit from a view into which member firms are actively identifying as engaged in bona fide market making activities under Regulation SHO.

Informative Short Sale Data Reform Requires Thoughtful Re-Design

The reporting rules related to short sale activity should be modified with the goal of providing investors and regulators with straightforward, understandable information about short selling activity. Investor short position disclosure should be made comparable to long position disclosure,[12] allowing market participants to readily determine the scope and extent of short positions in any given security. Under this overarching framework, we offer the following specific recommendations to improve the availability and utility of short sale data:

1. **Rule 4560 aggregate short sale data should be collected daily and reported on a delayed basis.** Firm position data is reliable and generally well understood by market participants. Making this data available more frequently would provide better data on overall short positions and general trends.

2. **All short sale reporting should bifurcate sales resulting from bona fide market making activities and all other short sale activities.** Rather than segregate total reportable short interest by proprietary/customer, as the RN proposes, firms should be required to distinguish between (i) short sales resulting from bona fide market making activity and (ii) all other short sales (*e.g.* agency trades). Bona fide market makers should be required to report aggregate, end-of-day positions (all purchases and sales) so the net daily change can be calculated. Publishing this information would benefit investors and regulators, both in understanding market maker participation and the overall liquidity provided by market makers.

3. **All intraday sales resulting from bona fide market making activities should be marked "bona fide market making short sales".** Trade reporting complexity and difficulties around race conditions would be reduced if all sales by bona fide market

[11] *See* FINRA Information Notice, "Understanding Short Sale Volume Data on FINRA's Website," (May 10, 2019), available at: https://www.finra.org/rules-guidance/notices/information-notice-051019.
[12] *See e.g.* 15 U.S.C. §§ 78m(d)-(h); 15 U.S.C. § 78p.

makers were eligible to be marked as such and segregated from all other short sales. This framework would help demystify market making activity, improve the FINRA daily volume information, and build elasticity into the system by providing bona fide market makers more time to deliver. It would also allow FINRA to more effectively monitor real-time trade reports to calculate any net short selling activity.

4. **All short sale data should be published on the same time schedule, so volume and position information are comparable.**

5. **Short sale data reform should include public disclosure of total shares held at the Depositary Trust Company ("DTC").** Distributing total short sale position data alongside aggregate shares held at DTC would be a valuable tool for investors and market participants. This DTC data is also useful for regulators to gain insight into the availability of shares in the clearing system. Enhanced disclosure of total shares held at DTC would help to prevent certain manipulative activities, such as short squeezes, which can occur in instances where a small number of shares are held in street name.

We believe the above recommendations would help create ***reliable data sources*** that bring greater understanding to short selling activities, discourage manipulative behavior, and allow market makers to provide short-term liquidity that reduces volatility.

We thank FINRA for taking the time to consider these important issues and seek industry feedback. We welcome the opportunity to discuss our comments with FINRA.

Respectfully submitted,

Daniel Zinn
General Counsel

Cass Sanford
Associate General Counsel