April 24, 2020

VIA ELECTRONIC DELIVERY

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (Release No. 34-87607; IA-5413; IC-33704; File No. S7-24-15)

Dear Ms. Countryman:

Virtu Financial, Inc. ("Virtu") respectfully submits this letter in response to the above-referenced proposed order issued by the Securities and Exchange Commission (the "SEC" or "Commission") on November 25, 2019 (the "Proposal")[1] concerning the use of derivatives by registered investment companies and business development companies; required due diligence by broker-dealers and registered investment advisers regarding retail customers' transactions in certain leveraged/inverse investment vehicles.

Virtu supports and recognizes the importance of the Commission's efforts to modernize the regulatory regime concerning the use of derivatives by registered funds. However, we believe that certain aspects of the Proposal are too blunt a tool to achieve the Commission's investor protection objectives, and in fact will actually harm investors. Specifically, we have significant concerns about the Proposal's suggested sales practice rules related to transactions in leveraged and inverse funds (the "Sales Practices Rules"). Although Virtu is a not a sponsor of leveraged or inverse funds, we facilitate transactions in them for our customers and believe they play an important role in the marketplace and in the portfolios of individual investors, including retail investors saving for college and retirement.

Because our principal concerns relate to the Sales Practices Rules, our comments below are focused on them. Specifically, we respectfully submit that the Sales Practices Rules:

- Represent an unprecedented example of merit-based regulation and a worrisome departure from the disclosure-based foundational principles of the federal securities laws;

[1] SEC Release No. 34-87607; IA-5413; IC-33704; File No. S7-24-15 (Nov. 25, 2019), *available at* https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

- Constitute an unnecessary solution to a non-existent problem and could send the Commission down a slippery slope toward merit-based regulation of other products;
- Would limit investor choice and are inconsistent with the Commission's recent efforts to expand retail access to the public and private capital markets;
- Ignore the robust regulatory framework that is already in place to protect investors in leveraged and inverse funds;
- Would impose needless costs that ultimately would be borne by investors; and
- Exceed the Commission's statutory authority.

The Sales Practices Rules Would Represent an Unprecedented Departure from the Disclosure-Based Principles of the Securities Laws

For over ninety years, the Commission has fulfilled its three part mission of protecting investors, promoting capital formation, and ensuring the orderly operation of the markets with a disclosure-based approach to regulation, consistent with the foundational principles of the federal securities laws. The SEC was never meant to be a merit-based regulator that gets to pick and choose which products customers can buy and which products they cannot. Imposing a "qualification test" here would be unprecedented – the first time in the Commission's history to add such a requirement to a securities transaction, and would be at odds with our long-standing system that gives investors and their advisors the freedom to make their own investment decisions.

As Commissioners Peirce and Roisman astutely observed in their statement about the Proposal:

> "The SEC protects investors not by limiting their right to access products available in public markets, but by ensuring that they have material information at the ready to make informed buy, sell, and hold decisions. Thus, wouldn't good disclosure about the leverage in these products obviate the need for this type of cap?"[2]

We strongly agree with the Commissioners that the disclosure requirements of our federal securities laws are more than adequate to apprise investors of the potential risks associated with geared products. Virtu has long been an ardent supporter of the existing disclosure-based regulatory construct and has routinely called for increased transparency to address problems in our markets.[3] Imposing a sales practice requirement here would constitute a form of paternalistic merit review and would be inconsistent with the disclosure principles of federal securities regulation.

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[2] Hester M. Peirce and Elad L. Roisman, Commissioners, U.S. Securities and Exchange Commission, *Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices* (Nov. 26, 2019), *available at* https://www.sec.gov/news/public-statement/roisman-peirce-statement-funds-derivatives-sales-practices.

[3] *See, e.g.*, Virtu Letter re: Proposed Transaction Fee Pilot for NMS Stocks (May 23, 2018) (advocating that conflict of interest concerns should be addressed through enhanced Rule 606 disclosures), *available at* https://www.virtu.com/uploads/2019/02/2018.05.23-Virtu's-Comment-Letter-Proposed-Transaction-Fee-Pilot-for-NMS-Stocks.pdf; Virtu Letter re: SEC Market Data and Market Access Roundtable (Oct. 23, 2018) (calling for increased disclosure and transparency by exchanges concerning market data and market connectivity revenues to

What's more, not only would such a requirement be unprecedented, it would set a very dangerous precedent going forward. It would send the SEC down a slippery slope whereby the current Commission – or future Commissions for that matter – would have discretion to decide which products customers are capable of understanding. As Commissioners Peirce and Roisman explained, "[t]o our knowledge, the Commission has not established a similar hurdle for investors attempting to buy or sell securities available in our public markets. Why would we introduce such a thing now, with respect to such a narrow subset of products?"[4] We are equally skeptical about the rationale for such a drastic departure from the Commission's historical approach to regulation.

The Sales Practices Rules are a Solution Without a Problem

In the Proposal, the Commission has singled out leveraged and inverse ETFs, but does not present compelling evidence that they should be treated differently than tens of thousands of other public securities, each with their own characteristics and risks. We respectfully submit that the proposed Sales Practices Rules are a solution without a problem.

We are concerned that the Commission has a misperception about the ability of investors to understand the risks associated with geared products. Investors have been using them for many years to seek enhanced returns or help protect their portfolios. As Professor James Angel of Georgetown University noted in his comment letter, leveraged and inverse products are not excessively risky when compared with other financial products and – in fact – are less risky and less complicated than many common stocks.[5] As a consequence, we struggle to understand why the Commission is singling these products out.

Furthermore, the disclosures offered by the issuers of such products are very robust. The potential risks are clearly explained, in plain English, in the issuers' prospectuses, shareholder reports, and on their websites. Take, for example, the prospectus for the ProShares Ultra S&P 500 Fund:

> "The return of the Fund for periods longer than a single day will be the result of its return for each day compounded over the period. The Fund's returns for periods longer than a single day will very likely differ in amount, and possibly even direction, from the Fund's stated multiple (2x) times the return of the Fund's Index for the same period. For periods longer than a single day, the Fund will lose money

promote competition), *available at* https://www.virtu.com/uploads/2019/02/2018.10.23-Virtu's-Comment-Letter-Roundtable-on-Market-Data-and-Market-Access.pdf; Virtu Letter re: SEC Proposed Order to Submit New NMS Plan (Feb. 25, 2020) (applauding SEC proposal to enhance transparency around governance of NMS plans), *available at* https://www.sec.gov/comments/4-757/4757-6865359-210617.pdf.

[4] *Id.*

[5] James J. Angel, Ph.D., CFA, Associate Professor, McDonough School of Business, Georgetown University, *Letter to Comment File* (Feb. 24, 2020), *available at* https://www.sec.gov/comments/s7-24-15/s72415-6856131-210491.pdf.

> if the Index's performance is flat, and it is possible that the Fund will lose money even if the level of the Index rises….
>
> The Fund presents different risks than other types of funds. The Fund uses leverage and is riskier than similarly benchmarked exchange-traded funds that do not use leverage. The Fund may not be suitable for all investors and should be used only by knowledgeable investors who understand the consequences of seeking daily leveraged (2x) investment results, including the impact of compounding on Fund performance. Investors in the Fund should actively manage and monitor their investments, as frequently as daily. An investor in the Fund could potentially lose the full principal value of his/ her investment within a single day."[6]

In our experience, this disclosure clearly and plainly describes to investors the potential risks associated with the fund. We do not agree with the notion that investors who are provided with such disclosure would be confused about the potential risks associated with them.

The Sales Practices Rules Would Limit Investor Choice and are Inconsistent with the Commission's Recent Efforts to Expand Retail Access to the Public and Private Markets

We worry that if the Sales Practices Rules are adopted, many broker-dealers and investment advisers would stop offering geared products altogether. Geared ETFs represent a relatively small segment of the marketplace – around $34 billion in AUM compared to total ETF assets of $3,081 billion as of September 2019.[7] Given the high costs and compliance burdens of implementing the changes that would be needed to comply, not to mention the potential risk of liability that would attach for infractions, it is highly likely that financial institutions would choose to simply walk away from transacting in such products.

As a consequence, investors who could benefit from the enhanced return and portfolio protection potential of leveraged and inverse funds could be prevented from buying them. We respectfully submit that this is inconsistent with the Commission's long-standing commitment to preserving free public markets where investors and their advisors have the freedom to buy public securities without additional government-imposed limitations on investor choice.

We also submit that the Sales Practices Rules are inconsistent with other initiatives this Commission has prioritized to increase investor choice. For example, the Commission recently issued a proposal to revise the Accredited Investor definition, in an effort to expand the pool of

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[6] Summary Prospectus, ProShares Ultra S&P 500 (Oct. 1, 2019), *available at* https://www.proshares.com/media/prospectus/sso_summary_prospectus.pdf.

[7] *See* U.S. Securities and Exchange Commission, Division of Economic and Risk Analysis, Economics Note: *The Distribution of Leveraged ETF Returns*, at 2 (Nov. 2019), available at https://www.sec.gov/files/DERA_LETF_Economics_Note_Nov2019.pdf.

investors who are eligible to invest in exempt offerings in the private markets.[8] On a number of occasions, Chairman Clayton has highlighted the fact that the vast majority of the investing public is unable to benefit from the growth of pre-IPO companies like Uber, and has indicated that the Commission is studying ways to increase investor access to the private markets.[9] And the Chairman has also expressed concern about the barriers companies face in accessing the public markets, resulting in fewer choices for investors.[10]

These actions and statements sound to us like a Commission that is prioritizing investor choice and that is focused on expanding the investing public's ability to access our capital markets. The Sales Practices Rules, on the other hand, are an anathema. On the one hand, the Commission appears committed to eliminating barriers for investors, but on the other hand is proposing to restrict the freedom of investors to make their own investment decisions.

There is Already a Robust Regulatory Framework in Place to Protect Investors in Leveraged and Inverse Funds

We respectfully submit that there is already a robust regulatory framework in place to address the Commission's concerns related to geared products.

With respect to broker-dealers, FINRA's comprehensive suitability rules require brokers to make a determination that a transaction in a geared product is aligned with the investor's risk profile, risk tolerance, and investment objectives, among other items. FINRA has also published guidance explaining the potential risks associated with geared funds[11] and reminding broker-dealers of their obligations related to them.[12] And, of course, less than a year ago, the SEC adopted

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[8] U.S. Securities and Exchange Commission, Press Release, *SEC Proposes to Update Accredited Investor Definition to Increase Access to Investments* (Dec. 18, 2020), available at https://www.sec.gov/news/press-release/2019-265.

[9] *See, e.g.*, Walter J. Clayton, III, Chairman, U.S. Securities and Exchange Commission, Remarks to the Economic Club of New York (Sept. 9, 2019) ("I just spoke about the power of choice, competition, and clear, investor-oriented rules in investment services. However, in the absence of access to a meaningful range of investment opportunities, those key principles have less impact. This is an issue of growing concern. I'll explain. We now have two segments in our capital markets…. The problem is, Main Street investors generally have access to only one hand—our public markets. They have extremely limited, and in many cases costly and otherwise less attractive, access to our private markets."), *available at* https://www.sec.gov/news/speech/speech-clayton-2019-09-09.

[10] *See, e.g.*, Walter J. Clayton, III, Chairman, U.S. Securities and Exchange Commission, Remarks to the Economic Club of New York (July 12, 2017) ("I have been vocal about my desire to enhance the ability of every American to participate in investment opportunities, including through the public markets. I also want American businesses to be able to raise the money they need to grow and create jobs. As I mentioned earlier, evidence shows that a large number of companies, including many of our country's most innovative businesses, are opting to remain privately held.… I believe we need to increase the attractiveness of our public capital markets without adversely affecting the availability of capital from our private markets."), *available at* https://www.sec.gov/news/speech/remarks-economic-club-new-york.

[11] FINRA, ETFs: What You Need to Know (Dec. 8, 2015), available at https://www.finra.org/investors/insights/etfs-what-you-need-know

[12] Regulatory Notice 09-31 FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds, *available at* https://www.finra.org/rules-guidance/notices/09-31.

Regulation Best Interest, which clarified and enhanced the role that broker-dealers play in ensuring that an investment is in the best interest of their customers. In our view, the Commission should evaluate whether Regulation Best Interest has addressed the perceived problem regarding retail investors' investment in geared products before promulgating yet another expensive and intrusive rule that is more likely to harm investors than to protect them.

Of course, Regulation Best Interest and the accompanying interpretations issued by the Commission also clarified the responsibilities of investment advisers, including that an adviser must base its advice to a client on a reasonable understanding of the client's objectives, requiring the adviser to make "a reasonable inquiry into the client's financial situation, level of financial sophistication, investment experience, and financial goals."[13] What's especially troubling about the Sales Practices Rules is that they would impose an additional duty on advisers who already have a *fiduciary duty* to make sure that an investment in a geared product is appropriate for their customer. Respectfully, we cannot understand how applying the Sales Practices Rules to investment advisers is justified.

Like Commissioners Peirce and Roisman, we too "struggle with the rationale for adding such a prescriptive requirement into our regulatory regimes that govern broker-dealers and investment advisers—regimes we comprehensively updated and clarified, after years of deliberation, only a handful of months ago."[14] We also agree with the Commissioners' characterization of the proposed Sales Practices Rules as "a requirement that would micromanage broker-dealers and advisers … in a way that appears neither necessary nor sufficient for them to meet their existing regulatory obligations."[15]

The Sales Practices Rules Needlessly Would Impose Significant Costs that Ultimately Would Be Borne by Investors

According to the Proposal, the SEC's Division of Economic and Risk Analysis (DERA) estimates that the total industry cost for the Sales Practices Rules would be an astounding $2.4 billion for broker-dealers and investment advisers – in the first year alone.

As the Commission surely recognizes, investors – including Main Street investors saving for college and retirement – will bear these costs because broker-dealers and investment advisers will need to pass them on to investors to remain profitable or to keep their profit margins competitive. We respectfully submit that the remarkably high costs of the Proposal are not outweighed by the potential benefit to investors, and would in fact harm investors by increasing their costs and lowering their returns.

[13] *See* Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Release No. IA-5248 (June 5, 2019), at 11-12.
[14] *Supra* n. 2.
[15] *Id.*

The Sales Practices Rules Exceeds the Commission's Statutory Authority

Finally, we respectfully question the Commission's statutory authority to adopt the Sales Practices Rules in the first place. While we agree that the Commission has an important, and statutorily mandated obligation, to govern the sales practices of broker-dealers and investment advisers, the proposed requirements go beyond that mandate – imposing an obligation on investors themselves to prove that they have sufficient "knowledge and experience" to be capable of investing in a publicly traded security. We do not see how this entirely new qualifications test imposed on individual investors fits within the statutory definition of "sales practice" under the securities laws.

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Virtu appreciates the opportunity to submit this response to the SEC's Proposal. We believe that the U.S. equity markets are the most robust, transparent and fair markets in the world, and that one of the most important attributes of those markets is the freedom of investors to make their own investment decisions. We strongly urge the Commission refrain from imposing an unnecessary and unprecedented barrier to investor access to our capital markets.

Respectfully submitted,

Thomas M. Merritt
Deputy General Counsel

cc: Walter J. Clayton, III, Chairman
Allison H. Lee, Commissioner
Hester M. Peirce, Commissioner
Elad L. Roisman, Commissioner
Dalia O. Blass, Director, Division of Investment Management
Brett W. Redfearn, Director, Division of Trading and Markets