February 3, 2021

By Electronic Submission

Janet Yellen
Secretary
Department of the Treasury
Chair, Financial Stability Oversight Council
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20520

Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Allison Herren Lee
Acting Chairperson
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Rostin Benham
Acting Chairperson
Commodity Futures Trading Commission
Christopher Kirkpatrick, Secretary
1155 21st Street, N.W.
Washington, D.C. 20581

John C. Williams
President and Chief Executive Officer
Federal Reserve Bank of New York
33 Liberty Street
New York, N.Y. 10045

Re: Regulatory Review of Market Structure and Related Issues Raised by Recent Retail Trading in GameStop and Other Equities via Brokers Such as Robinhood

Ladies and gentlemen,

Better Markets applauds you for convening a meeting of financial regulators to review and address the many recent market structure and regulatory issues raised by the frenzied trading in GameStop and other equities. We encourage you to expand what appears to be a de facto Financial Stability Oversight Council ("FSOC") meeting into a formal FSOC review and investigation to include and address the full range of issues impacting the fairness, safety and soundness, transparency, and efficiency of our financial markets. That would include, but not be limited to, the role of hedge funds, short sellers and other short interests and market participants in GameStop and related trading events; the misleadingly pitched "free" game-like trading via retail broker-dealers—like Robinhood—and the standards applicable to retail broker-dealers facilitating options and derivatives trading; the apparent disruptions to the price discovery process coordinated through the Reddit forum r/WallStreetBets (in addition to other social media platforms); the hidden and often detrimental effects of high frequency trading on retail investors through payment for order flow and trading venue rebate arrangements; the sufficiency of capital and liquidity risk management requirements for the small number of broker-dealers facilitating a very significant percentage of retail trading; and, the role and use of derivatives in recent market events, among other issues demanding immediate attention.

Before we address those issues in more detail below, there are two key points that must be kept in mind. First, while there must be a thorough investigation of the visible, headline events, the obvious must not be allowed to distract from the need for an equally thorough investigation into the fragmented, often predatory financial ecosystem that enables, if not incentivizes and guarantees, such disruptive and potentially dangerous activities. Furthermore, it is too often overlooked that only a handful of the very largest Wall Street banks and their subsidiaries and affiliates enable, fund and facilitate many of the trading practices at the center of the recent GameStop trading events. Our fragile financial markets have become far too dependent on this small number of bank groups, which have central roles in the operation and resiliency of clearinghouses, exchanges and trading venues, data repositories, and more. Beyond the financial markets infrastructure, those bank groups are also (1) the prime brokers for most of the hedge funds involved in the GameStop trading events, as well as hedge funds in the markets generally; (2) the biggest derivatives dealers maintaining the vast majority of derivatives exposures, (3) major market makers, broker-dealers, and traders and service providers to their competitors; and (4) significant lenders in various capacities, including as securities lenders. They also play numerous other roles in the financial system and, undoubtedly, in the transactions and activities at issue here.

Second, while the vehicles, methods and means for violating the law change, the duty to protect investors and markets while promoting systemic stability, capital formation, price discovery, and economic growth remain timeless and paramount. Today's laws, rules and regulations should be evaluated for the appropriateness of their scope and applicability, but regulators must nonetheless use their vast and ample authority and ability to address many of the issues raised by these recent events, including indications of illegal conduct that appear to have harmed many investors and caused very significant financial losses. Put differently, fraud, market manipulation and other illegal conduct are punishable regardless of forum or form and, therefore, should be charged as such regardless of whether it occurs at an open-cry tulip auction or via a cool app or subreddit channel. (Many of these issues were discussed in more detail in a recently issued Fact Sheet available here.)

That said, the recent trading in securities, derivatives and certain commodities has brought attention to longstanding and significant deficiencies in the structure of and regulatory frameworks governing our financial markets. It also has brought attention to a regrettable lack of supervision and enforcement of certain market practices, firms, and intermediaries. These events risk undermining confidence in our markets, as well as their fundamental price discovery, capital allocation, and risk management functions. Indeed, these recent events have called into question regulatory frameworks governing the disclosures and conduct of retail broker-dealers; have raised questions about the sufficiency of regulatory limits on short-selling and other avenues for establishing non-transparent short positions in securities (e.g., through derivatives); have reinforced the need to further clarify unlawful manipulative and disruptive practices (e.g., coordinated trading); and, have exposed other features of our market structure that give rise to conflicts of interest and practices that are often detrimental to investors (e.g., payment-for-order-flow arrangements that appear to incentivize brokers to subordinate their duties to their clients and expose retail investors to hidden execution costs exceeding typical retail trading commissions).

In the coming days and weeks, individual regulators must investigate and punish violations of the laws, while the regulators—ideally, directed and coordinated under the aegis of the FSOC, supported by the Office of Financial Research—simultaneously lead and coordinate a deep and comprehensive investigation into these events and deficiencies in the operation and structure of and regulatory frameworks governing our financial markets. As the FSOC commences this review, we encourage it to look beyond the precipitous rise and fall of GameStop and other so-called "Reddit Rebellion" equities and derivatives and to address the following market structure and other issues brought to light or highlighted by those activities:

- Reviewing the Scope and Applicability of Regulations Governing Manipulation, Trading Coordination: The recent trading patterns in GameStop and other equities, as well as silver futures markets, raise questions about whether certain traders may have engaged in unlawful manipulation and/or disruptive trading. The manipulation standards most clearly apply to trading activities intended to influence prices of financial instruments by disseminating false information or engaging in deceptive trading practices that create a false impression about the level of interest in the stock, its value, or its price direction. Media reports indicate that retail traders may have coordinated to purchase GameStop shares, perhaps to put upward pressure on its share price and force institutional short sellers to cover their positions and put even more upward pressure on share prices (i.e., to effect a "short squeeze"). There are also reports that hedge funds and other sophisticated participants (such as high-frequency traders) took advantage of the momentum and pushed up the prices of these "meme stocks."

These facts raise several critical questions that must be addressed, including: (1) whether some class of retail investors demonstrably intended to engage in manipulative trading practices to effect a short squeeze; (2) whether retail investors actually caused the short squeeze in GameStop, for example, or whether other trading interests took advantage of retail trading momentum and/or withdrew liquidity to exacerbate or cause the upward price pressures; (3) whether institutional investors were engaged in manipulative practices, including through trading on incoming retail customer orders or their extensive short selling in equities; (4) whether certain traders that were publicly encouraging purchase or retention of GameStop and other equities were simultaneously selling to secure profits or limit losses; and (5) whether definitions and prohibitions on market manipulation and manipulative trading practices in statutes as well as SEC and CFTC regulations and interpretations fully cover such practices.

- Evaluating the Best Execution Standard: Under the best-execution standard, retail broker-dealers must exercise reasonable care in handling, routing, and executing customer orders. Furthermore, broker-dealers must use reasonable diligence to ascertain the best market for a security and execute customer orders in such market as favorably as possible under prevailing market conditions. Retail broker-dealers that route trades to executing dealers, including Robinhood, nevertheless have been found by the SEC to have failed to compare execution quality under their order routing arrangements to the execution quality that customers otherwise could have obtained in competing markets as required by law.[1]

  The SEC must consider the following: (1) whether it and the Financial Industry Regulatory Authority ("FINRA") have sufficient order routing and execution visibility to permit comparisons of execution quality and ensure compliance with the best-execution standard; (2) whether periodic review requirements with respect to the best execution standard sufficiently protect investors, given that trade-by-trade analyses and testing apparently are not expected or occurring; (3) whether the multi-factor best execution standard should apply to the most active retail broker-dealers—the handful of "super brokers" responsible for most retail trading—in lieu of a standard more strictly focused on pricing; and (4) whether the multi-factor best execution standard is appropriately enforceable.

- Ban Payment-for-Order-Flow: Many, but not all, retail broker-dealers offer "commission-free trading,"[2] while routing customer orders to executing dealers for internalization or execution in

[1] See SEC administrative and cease-and-desist proceeding *In Re Robinhood Financial* (Dec. 17, 2020) available at https://www.sec.gov/litigation/admin/2020/33-10906.pdf.

[2] Regulators must also analyze whether or not the trumpeted claims of "commission free trading," which are heard as "free trading" by many retail investors, is a fraudulent and misleading statement or operates as such to a reasonable investor absent additional disclosure of the costs associated with that trading. For further discussion, see Better Markets' Fact Sheet "Reddit, Robinhood, GameStop & Rigged Markets: The Key Issues for Investigation," available at

market centers. The practice of broker-dealers receiving rebates in connection with orders routed to these select broker-dealers—payment-for-order-flow ("PFOF")—is widespread and causes an inevitable conflict-of-interest between the retail broker-dealer's duties to seek best execution for its customers and its duties to shareholders and others to maximize revenues. Although price improvement on routed trades relative to the national best bid or offer apparently occurs with some frequency, a multi-billion dollar "hidden tax" on execution of retail customer orders is apparently nevertheless exacted with some frequency as well—in part because of the identified issues with respect to the best-execution standard intended to mitigate such conflicts. These execution costs often far outweigh the benefits to retail investors associated with so-called "commission-free trading." Thus, given that these conflicts of interest cannot be mitigated to adequately protect investors, the practice of PFOF should be banned.

If the SEC does not prohibit PFOF arrangements notwithstanding the clear conflicts-of-interest and difficulty, if not impossibility, of overseeing and enforcing the best-execution standard explained above, it should immediately undertake an investigation of the following and issue a public report detailing all findings and data: (1) whether PFOF provides demonstrable benefits to retail investors that sufficiently outweigh the known execution costs associated with the practice, especially with respect to retail investors using the handful of "super brokers" responsible for the vast amount of retail order flow; (2) whether retail broker-dealers choosing not to route customer orders to executing dealers and therefore choosing to forego PFOF revenue obtain superior execution on customer orders and yet have a sustainable retail business model; (3) whether execution quality increased subsequent to prohibitions on PFOF in other jurisdictions; and (4) whether order routing incentives at exchanges and other trading venues further incentivize inferior executions through rebate schemes and/or asymmetric order execution practices intended to benefit market-makers.

- Evaluate the Gamification of Trading: Robinhood appears to have perfected the gamification of trading by incorporating the addictive, endorphin-engendering game features of more benign apps into its trading app for the purpose of triggering more trading more often and more thoughtlessly. Thus, it is taking an activity—investing and risking money—that has historically been viewed as requiring thought, diligence, analysis and financial wherewithal and imbuing it with rapid, seemingly low-consequence and fundamentally recreational game playing. Needless to say, investing in markets is not a game, but involves the making and losing of vast sums of money, often in a very short period of time. The concerns here are not limited to protecting individual investors, however important that may be. Irrational investing, particularly at scale, has effects that reach far beyond the individual investors involved and can adversely impact, among other things, company valuations, capital allocation, and capital formation, and implicate market and systemic stability.

  Regulators should, at a minimum, review (1) whether a registered broker-dealer can satisfy its legal duties to its investor clients with such a product, and (2) whether broker-dealers, in practice, are balancing the communications and interfaces emphasizing the profitability and ease of trading with equally compelling and conspicuous information concerning the costs and risks of trading, including the risk of very substantial costs and losses in very short periods of time. The latter would be especially important with respect to options trading that reportedly has been at the center of GameStop's rapid and irrational price increases to market values far in excess of other companies with substantially more fundamental value support.

- Consider Reforms to Retail Broker-Dealer Capital and Liquidity Risk Management Requirements: In the course of intense public scrutiny of events surrounding GameStop and other equities,

---

https://bettermarkets.com/sites/default/files/documents/Better_Markets_Reddit_Robinhood_Gamestop_RiggedMarkets_02-01-2021.pdf.

Robinhood initiated a number of ad hoc purchase—but not sale—halts on a number of securities, perhaps unfairly advantaging short positions in the market. In doing so, Robinhood explained, in essence, that these were defensive measures intended to protect against unspecified financial requirements arising from the extraordinary volatility in certain securities and its clearing agencies' own protective measures. (This again makes clear the ripple effects of one action throughout the entire financial system, again reinforcing the imperative for FSOC to conduct a comprehensive investigation of all market participants and activities associated with or connected to the recent market events.)

The SEC must consider the following: (1) whether broker-dealer capital and liquidity risk management requirements sufficiently protect retail investors against risks in extreme but plausible market conditions and sufficiently contemplate the effects of procyclical, defensive measures likely to be taken by clearing agencies and counterparties; (2) whether Robinhood, specifically, experienced liquidity shortfalls or other financial distresses, and the nature of the exact causes or drivers of such shortfalls and/or distress; (3) whether Robinhood, specifically, and broker-dealers in general have written policies, procedures, and controls to govern determinations to impose trading halts, and whether asymmetric trading halts should be permitted at all; (4) whether any trading halts by retail broker-dealers should be effected only after a public notice period has expired; (5) whether there should be closer coordination between broker-dealer trading halts and exchange trading halts or circuit breakers, and the implications of these market and broker-dealer limitations for investor protection; and (6) whether Robinhood had undisclosed financial motives for imposing an asymmetric trading halt.

- <u>Immediately Complete and Operationalize the Consolidated Audit Trail and Expand Its Capabilities to Collect Real-Time, Comprehensive Data</u>: To surveil and police today's ever-expanding, fast-moving, multifaced markets, as well as to consider effective policy improvements in light of recent GameStop and related events, the SEC and CFTC must have access to timely, accurate, and complete information on trading activities occurring in the securities and derivatives markets. Since at least the "Flash Crash" in May 2010, it has been long-recognized that the SEC has needed a consolidated audit trail ("CAT") on all trading-related activities in the financial markets. Once operationalized, the CAT will collect and reflect granular order, cancellation, modification, and trade execution information and enable the SEC and other regulators to reduce, manage, and better understand market disruptions, distortions, and crashes, including anomalous trading events like the GameStop frenzy, and identify, deter, and punish manipulative, disruptive or other illegal trading activities.

  Under FSOC's supervision and support, the SEC must immediately consider the following: (1) whether it should continue to outsource construction and operation of the CAT to the industry or the industry's representatives in light of the many crippling conflicts of interest and repeated failures to meet deadlines and operationalize the now years-old project; (2) whether conflicts-of-interest embedded in the CAT's governance structure have impeded implementation and thereby denied the SEC a valuable tool needed to assess recent GameStop trading and related market activities, and whether those conflicts of interest will continue to plague the CAT once it is operational; (3) whether recent changes to the CAT NMS Rule would make it more difficult for regulators to detect manipulation and identify manipulators, and whether those changes have made the CAT user-unfriendly; (4) whether transparency measures and significant penalties can be adopted near-term to increase accountability and the rapid construction, deployment and operation of the CAT; (5) whether accelerated phased implementation of certain order and trade execution information would better facilitate near-term completion of the CAT; and (6) whether the SEC should upgrade CAT with an eye towards real-time reporting (as originally envisioned by the SEC in 2010).

- <u>Explore Ways to Increase Short Interest Transparency</u>: Some trading in GameStop and other so-called "Reddit Rebellion" equities was apparently motivated by objections to the short selling activities of institutional traders. There is some transparency with respect to short interests acquired through traditional short selling activities. Market participants frequently rely on put-call, short-interest, and days-to-cover ratios, for example, to gauge market sentiment on valuations, and some of these short-interest measures are informed by bi-monthly reporting by broker-dealers. However, these measures understate the short interest acquired through derivatives, including cash-settled derivatives, that provide leveraged downside exposures to securities, or baskets of securities, without any purchase or sale of the underlying securities.

  The SEC must consider the following: (1) whether to increase the frequency and expand the scope of short interest reporting by broker-dealers and consider reporting obligations by other market participants; (2) whether the SEC should revise Form PF to provide greater transparency of short positions (as envisioned by Section 404 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010); (3) whether regulators and market participants have access to timely and complete information on short interest, including short interest acquired through equity derivatives; and (4) whether SEC registrants, including security-based swap dealers, are reporting sufficient information to enable oversight of trading activities conducted in connection with related short interest.

Better Markets appreciates your attention to recent market events and encourages careful consideration of the above issues as well as those identified in our February 1, 2021 Fact Sheet "Reddit, Robinhood, GameStop & Rigged Markets: The Key Issues for Investigation," available at https://bettermarkets.com/sites/default/files/documents/Better_Markets_Reddit_Robinhood_Gamestop_RiggedMarkets_02-01-2021.pdf. Given the fluid, fast-moving events and incomplete publicly available information, there are undoubtedly other issues that need to be explored and investigated. Nevertheless, we hope the issues identified herein and in the Fact Sheet are helpful as you consider additional measures to address investor protection and improve our financial market structure and regulatory frameworks. We conclude by noting, as we did above, that reviews and evaluations should not in any way interfere with the aggressive enforcement of existing laws, rules and authorities governing today's markets, which must be applied to any and all market participants without fear or favor.

We would be pleased to discuss these or any related events which would be helpful to the FSOC or the individual regulators in relation to these matters.

Sincerely,

Dennis M. Kelleher
President and Chief Executive Officer

Joseph R. Cisewski
Senior Derivatives Consultant and Special Counsel

Lev Bagramian
Senior Securities Policy Advisor

Stephen Hall
Legal Director and Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

www.bettermarkets.com

CC: The Honorable Adewale Adeyemo, Deputy Secretary, Department of the Treasury
Commissioners of the SEC and CFTC
Members of the Board of Governors
Sen. Sherrod Brown, Chairman, and members of the Senate Banking Committee
Sen. Ron Wyden, Chairman, and members of the Senate Finance Committee
Sen. Debbie Stabenow, Chair, and members of the Senate Agriculture Committee
Honorable Maxine Waters, Chair, and members of the House Financial Services Committee
Honorable David Scott, Chair, and members of the House Agriculture Committee