BETTER MARKETS

Highlights of the Third GameStop Hearing: SEC Chairman Gary Gensler In His Own Words on Four Key Policy Issues

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On May 6, 2021, the Securities and Exchange Commission ("SEC") Chairman, Gary Gensler, appeared before the House Financial Services Committee ("Committee") for its third hearing on the GameStop trading frenzy and related events. Better Markets again applauds Chairwoman Maxine Waters and her colleagues for bringing much-needed attention to recent events and the frailties, deficiencies, and defects of our securities markets and regulatory frameworks. Thanks to these efforts, Chairman Gensler had an opportunity to expand upon his views in key regulatory areas implicated by the GameStop frenzy: (1) payment for order flow; (2) short selling; (3) settlement timeframes; and (4) gamification of trading.

This brief fact sheet captures SEC Chairman Gensler's views—in his own words—on four key issues raised in the May 6 hearing. It does not, however, cover the full range of critical issues that must be addressed by the SEC Chairman in the coming weeks. For our recent views on the SEC's broader agenda, *see* Dennis Kelleher's op-ed, *A Policy Agenda for Wall Street's New Sheriff: The Specific Areas Where New SEC Head Gary Gensler Needs to Act Over Rigged Markets* (a more comprehensive version is available on our website here). For our views on the SEC's enforcement agenda and what the agency must do to stop an ongoing financial crime spree in our securities markets, *see* Dennis Kelleher's op-ed, *Putting the SEC Cops Back on the Wall Street Beat*.

Fortunately, in the May Committee hearing, Chairman Gensler signaled the need to consider meaningful reforms in the four mentioned policy areas. Unfortunately, with certain exceptions, Chairman Gensler at this stage merely expressed an intent to think about, discuss, study, review, and/or request comment key policy questions, leaving open a broad range of possibilities with respect to the outcomes of the SEC's future agenda.

In our view, Chairman Gensler was as transparent with his views as could be reasonably expected under the circumstances, given that he only recently took office, almost certainly is still developing his policy views, and has yet to fill almost all of the key senior staff positions at the SEC that would inform those views. Nevertheless, as we discuss *below*, Chairman Gensler must take decisive and bold action—not merely symbolic action—in the coming weeks. Better Markets expects both to continue to work with him and hold him accountable for the long overdue regulatory changes needed to protect investors, ensure fair, orderly, and efficient markets, and support capital formation.

I. *Payment for Order Flow*: Chairman Gensler recognized the harms to investors and markets arising from the practice of payment for order flow but stopped short of advocating for a prohibition or outlining specific remedial actions.

Better Markets has published a Long Fact Sheet and White Paper explaining the harmful consequences of the practice of payment for order flow ("PFOF"). Our views can be summarized as follows: First, PFOF creates clear conflicts of interest that cannot be adequately mitigated by disclosure and best-execution requirements. As a result, PFOF costs investors billions of dollars in what amounts to a hidden tax on retail trade execution. Second, PFOF is both a *cause* and a *consequence* of the needlessly fragmented system of created complexity that has become the hallmark of the U.S. equity market structure. That market structure is routinely gamed and exploited by a handful of HFTs that internalize (privately trade against) the vast majority of U.S. retail order flow. PFOF entrenches those HFTs, which likely pose a systemic risk to our financial system.

Third, PFOF siphons trading away from the transparent exchanges and segments order flow, sabotaging opportunities for buyers and sellers of securities to meet each other in "lit," impartially accessed, efficient markets. This, in turn, all but forces those "lit" exchanges to provide their own inducements (*e.g.,* special trading protocols, order types, data streams, and market access privileges) to HFTs for competitive reasons (*e.g.*, so that the exchanges can stem the losses of order flow). Regrettably, the HFT-inducements arms race and bidding war and the similar dynamic occurring more broadly between dark and lit markets complexifies our market structure and, ultimately, advantages a small number of HFTs to the detriment of everyone else—including pension funds, the buyside generally, and especially retail investors. It also affects financial stability.

Where is SEC Chairman Gensler on the issue of payment for order flow?

Chairman Gensler's Known Views	Better Markets' Assessment
1. Chairman Gensler acknowledged conflicts of interest created by PFOF: "This practice [of PFOF] brings to mind a number of questions, including whether it creates inherent conflicts of interest between the broker dealers on one side and their customers on the other who want to achieve, under our rules, best execution." "[W]e've found conflicts and various enforcement cases like [the Robinhood] one that we filed in December . . . So we know at least from that case, this inherent conflict is there and whether we can address it enough through disclosure or not sort of implicates the broader market structure." "[C]ertain principal trading firms seeking to attract Robinhood's order flow told them that there was a tradeoff between payment for order flow and price improvement for customers. Robinhood explicitly offered to accept less price improvement for its customers in exchange for receiving higher payment for order flow for itself. As a result, many Robinhood customers shouldered the costs of inferior executions; these costs might have exceeded any savings they	The new SEC Chairman clearly articulated the core issues raised by PFOF and appears to be interested in taking remedial actions. However, at this time, he has committed only to taking a "closer look" at the problem and issues in the overall context of the U.S. equity market structure and appears to have left open the possibility of emphasizing improved PFOF disclosures, which would do little to improve retail execution, much less improve the needlessly complex and fragmented U.S. equity market structure. In our view, the new Chairman's deliberate approach of holistically considering PFOF issues at this early stage is reasonable. In the coming weeks, though, we expect decisive, bold, and politically courageous SEC action—which must go far beyond mere disclosure—to address the multiple distortive and harmful PFOF effects that the Chairman himself has acknowledged.

might have thought they'd gotten from a zero commission." "[I]t's interesting to note that neither the United Kingdom nor Canada permits broker-dealers to route retail orders to off-exchange market makers in return for payments." 2. <u>Chairman Gensler acknowledged risks associated with the concentration of order flow in a small number of HFTs</u>: "Now it's important to consider this, I think, in the overall context of market structure. Currently, a significant amount of retail orders are routed to a small number of wholesalers . . . I think it raises questions about whether the market structure best promotes fair, orderly and efficient markets. Evolving market technologies along with this payment for order flow have also led to increasing market concentration, which we've found—history and economics show—concentration can lead to fragility in markets, deter healthy competition and limit innovation." "[T]he wholesalers get valuable information from this order flow that other market participants get with a delay, if at all." 3. <u>Chairman Gensler acknowledged the need to holistically address both broker-to-broker PFOF and exchange-to-broker PFOF:</u> "For that order flow, and it can be in conflict with the interest of that customer. And that inherent conflict, we found in a case that was settled in in December . . . And so I think that that's why we need to take a closer look at that, but also in the context of the overall equity market structure because there's also payment for order flow on exchanges, which is called rebates. So there's other pieces of this puzzle, not just the wholesalers." "I guess they have to think about that broader market structure and not just the wholesaler payment order flow, but also the exchanges, the rebates and just how is this market structure has led to concentration? So right now we have a pretty highly concentrated and growing concentration in the retail order flow."	

II. ***Short Selling*: Chairman Gensler's focus on additional short-selling transparency is positive and necessary but leaves unaddressed other essential measures, including improved market-wide guardrails, settlement requirements, and monitoring and enforcement.**

Better Markets has published 10 recommendations for short-selling regulatory enhancements that would improve transparency, increase market stability and efficiency, reduce operational risk, and prevent abusive trading and manipulation. Our views on short selling can be summarized as follows: Short selling ***can*** be one component of a well-functioning, liquid securities market and ***can*** contribute useful information to the price discovery process, *under the right regulatory conditions*. However, short selling also ***can*** interfere with fair, orderly, and efficient markets and substantially distort the price discovery process, *under the wrong regulatory conditions*. It thereby can adversely impact the operation and price of capital for companies, especially early stage companies vulnerable to unlawful or abusive short-selling practices.

The SEC's current regulatory framework, unfortunately, does not meritoriously balance these considerations but, rather, all but ensures that certain short-selling practices can continue to impose harms on companies, investors, and markets. For short selling to serve a constructive—as opposed to destructive—role in our securities markets, the SEC must implement reasonable short-selling (1) transparency requirements, (2) regulatory safeguards, (3) operational improvements, and (4) monitoring and enforcement measures to protect fair, orderly, and efficient trading, level the informational and trading playing field for investors, and better serve issuers (companies), investors, and the purposes of the securities markets—*i.e.,* to support capital formation and the integrity of the price discovery process that informs capital allocation.

Where is SEC Chairman Gensler on short selling issues?

Chairman Gensler's Known Views	Better Markets' Assessment
1. Chairman Gensler has directed SEC staff to prepare recommendations with respect to new monthly aggregate short-sale disclosures and new transparency measures for the securities-lending markets: "At the center of January's market events was significant short selling of a number of the meme stocks. While FINRA and the exchanges currently publish or make available certain short-sale data, Congress directed the SEC under the Dodd-Frank Act to publish rules on monthly aggregate short-sale disclosures. In addition, Dodd-Frank provided authority to the SEC to increase transparency in the stock loan market. I've directed SEC staff to prepare recommendations for the Commission's consideration on these issues." "Short selling has been part of our market structure for many decades—in fact, even before the securities laws. Economists have many studies, and there have been many debates on short selling . . . [W]e do think	The SEC Chairman has asked the SEC staff to prepare recommendations for a rulemaking (proposal) that would increase short-selling transparency, likely through monthly aggregate short-sale disclosures. The Chairman also has asked the SEC staff to consider "whether" to include equity derivatives in the short-interest transparency proposal. Although the Chairman's staff directives are positive, Better Markets will reserve further comment until it has a better sense of what the SEC is contemplating with respect to these transparency initiatives. The "devil will be in the details," so to speak. However, we can think of no legitimate reason that long overdue derivatives-related short-interest disclosures should remain an open question. Importantly, the SEC Chairman has not publicly addressed other short-selling measures. For example, Better Markets has identified elements of Regulation SHO that should be reconsidered (*e.g.,* the Market-Maker Exception to the Locate Requirement), and we have called for strict, mandatory buy-ins, with punitive fee assessments, to address failures-to-deliver ("FTDs") in the settlement

that there's a need for greater transparency in the short selling side . . . Congress has already directed that we have greater transparency in the short selling side." 2. <u>Chairman Gensler acknowledged the Congressional directive for additional short-selling disclosures and rightly views short-selling and securities-lending transparency as mandatory.</u> "Congress anticipated and gave authorities to the SEC to, on a monthly basis, require aggregate information in the short selling market . . . I think that transparency is positive to markets, and I've asked staff to put forward recommendations to our five member commission. It was actually a mandate from Congress. It wasn't a "may," it was a "shall." So we're going to lean in and follow Congress' mandate from 12 years ago." 3. <u>Chairman Gensler directed SEC staff to consider recommendations with respect to "whether" equity derivatives should be included in short-interest disclosures</u>: "I've asked staff to consider recommendations for the Commission about whether to include total return swaps and other security-based swaps under new disclosure requirements, and if so how." 4. <u>Chairman Gensler acknowledged the importance of using the SEC's enforcement tools to detect, punish, and deter manipulation involving short selling</u>: "I think that short selling which is probably as old as capital markets—several hundred years or more—does play a role in capital markets and price formation. The important tenet for the SEC is to ensure that the markets are free of fraud and manipulation and so those participants in the market, whether they're [trading] on the buy side or long side or on the short side, are doing so without defrauding or manipulating the markets. And then there's the appropriate transparency."	process for short sales. In addition, Better Markets has called for consideration of market-wide guardrails, like a potential short-position-limits framework that would be instituted only once the short-selling interest in a particular security exceeds a pre-determined percentage of the total tradeable float and/or potential reinstatement of the Uptick Rule. None of those issues were addressed by the Chairman.

III. ***Securities Settlement*: <u>Chairman Gensler announced his intent to pursue T+1 settlement of securities transactions and to explore even more aggressive settlement timeframes.</u>**

Better Markets has called on the SEC to shorten the settlement cycle to T+1 (*i.e.,* trade-date-plus-one-trading-day), which would reduce operational and other risks in our settlement system, including risks associated with FTDs and short selling. The securities markets currently operate on a T+2 time horizon. Because margin models at the National Securities Clearing Corporation account for risks during the period of time that elapses between the trading and settlement of transactions, a shorter time horizon for settlement— like T+1 or T+0 (Evening)—would not only reduce risks to the clearing and settlement system but also generally reduce liquidity demands and risks to clearing firms that must meet margin calls calibrated to the risks and volatilities expected for the firm's overall portfolio during the unsettled risk period. The shortened T+1 or T+0 (Evening) settlement period also may diminish the number of unsettled transactions arising from the short-sale re-lending process.

Where is SEC Chairman Gensler on the securities settlement period?

Chairman Gensler's Known Views	Better Markets' Assessment
1. <u>Chairman Gensler has directed SEC staff to prepare a rulemaking (proposal) shortening the settlement cycle to at least T+1</u>: "With regard to the settlement cycle, I'm reminded of an old saying in the markets: 'Time equals risk.' These events have prompted questions about whether we can lower risk by shortening the time of our settlement cycles. Interestingly, if one goes back to the 1920s, our capital markets had a one-day settlement cycle. This was prior to the establishment of the SEC, so it was a matter of convention rather than a regulatory requirement. Throughout the 20th century, the length of the settlement cycle ebbed and flowed; it was as long as five days. In 2017, the SEC adopted a rule to shorten the standard settlement cycle from three days (T+3) to two days (T+2). The Depository Trust & Clearing Corporation and other industry groups recently announced their intention to study these issues and collaborate on efforts to accelerate the transition to T+1. The longer it takes for a trade to settle, the more risk our markets assume. The good news is, though it will take a lot of work by many parties, we now have the technology to further shorten the settlement cycles,	The SEC Chairman has asked the SEC staff to prepare recommendations for a rulemaking (proposal) that would shorten the current T+2 settlement cycle to T+1 and perhaps T+0 (Evening) over time. Better Markets supports the T+1 settlement-period proposal, and we applaud the SEC Chairman for his consideration of a more aggressive T+0 (Evening) settlement period, which, as noted, would reduce risk throughout the clearing and settlement system.

not only to the settlement cycle we had a century ago, but even to same-day settlement (T-0 or 'T-evening'). I believe shortening the standard settlement cycle could reduce costs and risks in our markets.I've directed the SEC staff to put together a draft proposal for the Commission's review on this topic." 2. <u>Chairman Gensler has stated that same-day settlement—T+0 (Evening)—is technologically feasible, with a reasonable transition period</u>: "So I think technology exists to come to same day settlement. There are real savings, lower costs, and lower risk. The question about same day settlement, 'is it still netted?,' as Mr. Bodson [DTCC] pointed out. Netting is a really important piece of the economics. But you could have same-day-evening, so to speak, and have it all netted. But there obviously are transition costs. Moving from T+5, to T+3, to T+2 took time. I note in the 1920s, we were at T+1. So getting back to T+1 one-hundred years later, with modern technology . . . I want to say that we can get to T+1, and we can get to T+Evening. But it will take some time."	

IV. <u>*Gamification of Trading*: Chairman Gensler has expressed concerns about broker-dealers employing existing and emerging technologies and strategies to encourage impulsivity, develop addictions, nudge, and/or manipulate investor-users.</u>

Four congressional hearings have now raised the issue of so-called "gamification." One thing is clear: So-called "gamification" is not being employed to "democratize finance" or to provide a more "delightful experience" to investor-users (as Robinhood's CEO has disingenuously testified). *Gamification* is, in reality, a means for *exploitation* of retail traders via a technologically sophisticated wealth extraction mechanism.

Robinhood appears to have incorporated 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. Why? Gamification is part of its business model dependent on PFOF revenues. PFOF revenues depend on Robinhood's customers engaging in as much trading as possible. Robinhood figured out that providing "commission-free" trading (which most investors incorrectly hear as "free trading") and integrating game-like features into its trading app facilitates the extraction of revenue ***from*** its customers because of the well-known reality that consumers will use more of a good or service believed to be entertaining and "free." That is even more the case when the ostensibly free product is packaged to induce addiction.

In short, Robinhood's provision of "commission-free" and game-like trading is a profit-maximizing business strategy that is designed to induce customers to trade repeatedly and thoughtlessly, which, of course, presents more opportunities for a handful of HFTs, like Citadel Securities, to internalize those trades at a profit and share those profits with Robinhood via PFOF.

Where is SEC Chairman Gensler on the issues presented by the gamification of trading?

Chairman Gensler's Known Views	**Better Markets' Assessment**
1. <u>Chairman Gensler has directed SEC staff to prepare a request for public comment</u>: "Following the wrong prompt on a trading app . . . could have a substantial effect on a saver's financial position. A big loss could have immediate implications for the app user's ability to afford their rent or pay other important bills. A small loss now could compound into a significant loss at retirement. Many of these features encourage investors to trade more. Some academic studies suggest more active trading or even day trading results in lower returns for the average trader. It's in this context that I've asked staff to prepare a request for public input for consideration of these issues. We need to ensure investors using apps with these types of features continue to be appropriately protected and consider how all of our rules apply in these situations, including Regulation Best Interest. In addition, many of our regulations were largely written before these recent technologies and communication practices became prevalent. I think we need to evaluate our rules, and we may find that we need to freshen up our rule set. If we don't address this now, the investing public—those saving for their futures, retirements, and education—may shoulder a burden later." "This term, 'gamification,' which means embedding game like features into applications, does not just relate to finance; it relates to our whole online existence . . . I'm kind of a RomCom guy here—if I watch a RomCom that they recommend, and I lose an hour and a half and it was a lousy RomCom, it's alright. But if you use gamification features and folks are trading more actively or day trading, then all of the sudden that's their investment future . . . that presents challenges for their future and for their security. So I think we really have to take a look at this. We've asked the staff to put together . . . requests for public comment about all of these features that are getting imported into finance . . . if it's sort of churning folks or getting them to invest or trade a lot, what does that	The SEC Chairman has directed the SEC staff to prepare a request for comment on common "gamification" features reflected in finance apps. This is a useful and necessary information gathering exercise, and the SEC should stay on top of technological developments affecting retail investors, especially uses of technology that may be designed specifically to encourage impulsivity, develop addictions, nudge, and/or manipulate investor-users. The Chairman has hinted that the forthcoming request for comment would address app features, nudges, or conveniences that might trigger broker-dealer duties and requirements, including those under Regulation Best Interest ("BI"). To maximize meaningful public input, however, the SEC's request for comment must be reasonably specific with respect to existing trading app practices and features that may bring self-directed trading into scope for Regulation BI or other duties and requirements. The public must be asked to comment on <u>identified practices and app design elements</u> that go far beyond just Robinhood and might be viewed as tantamount to providing "recommendations," for example, not general principles or general "gamification" concerns alone. For this reason, we encourage the SEC to conduct examinations of at least the most active retail broker-dealers' trading app practices and design elements prior to issuing a request for comment. Without the information necessary to understand practices and design elements actually employed by retail broker-dealers, the SEC cannot be expected to reveal much to the public, much less provide a useful basis for a request for comment, and the public cannot be expected to provide informed, actionable comments. More broadly, the potential regulation of evolving trading app features—in one form or another—raises novel and complex questions that will require ongoing monitoring and evaluation. We continue to consider gamification issues ourselves but suspect that trading app features likely will have to be addressed through an iterative process in which the SEC and FINRA identify and take regulatory and/or supervisory action to curtail <u>specific</u>

mean and what protections should we have in there and those communications?" "I think what we found in our modern internet age is that service providers outside of finance figured out how to basically engage us in a more fun app and make the user experience more enjoyable . . . That can be good because it's easy to use the app, but it also can lead to high trading activity and that high trading activity is really important. Tie that with predictive data analytics—some fancy words like deep learning and machine learning to tie that to predictive data analytics—then, they can say to Gary Gensler, this is the prompt you're gonna get. And they can send say to Chair Waters, this is the prompt she's going to get. And then they figure out—the computers figure out—how to market to us differently, and all of a sudden it becomes somewhat potentially behaviorally addictive, and you start to find that your returns go down. So I think it's a very important thing we're putting out to public comment to find from the public more about this area. I think it's best to get ahead of it rather than five years from now."	practices and <u>specific</u> design elements viewed as particularly exploitative. However, this approach is almost certain to result in a "whack-a-mole" problem in which broker-dealers adopt endless deviations or permutations of identified practices and elements, which is a regulatory avoidance issue that is not unique to gamification. That, however, must not detract from the public need for much more information on these tactics and strategies as well as the SEC and FINRA mandates to protect investors regardless of the form those practices and design elements take. In our view, the Chairman's information gathering exercise, in addition to bringing sunlight to the actual practices and design elements used to encourage impulsivity, develop addictions, nudge, and/or manipulate investor-users, will also provide an informed basis for both public and regulatory action.

Although the third GameStop hearing left numerous market structure, disclosure, and regulatory issues unaddressed, Better Markets was encouraged by the new SEC Chairman's comments in the *above* mentioned regulatory areas. Yet, we emphasize, again, that Chairman Gensler has largely expressed an intent to think about, discuss, study, review and/or seek public comment on key policy questions, leaving open a broad range of possibilities with respect to the outcomes of the SEC's future agenda.

As the SEC proceeds with that agenda, Better Markets will continue to represent the views of retail investors and working families too often left out of the policy conversation in Washington, D.C. Unfortunately, ripping off the buy side and exploiting retail investors is lucrative, and a fraction of that money is used—too often successfully—to amplify self-serving industry narratives and buy access and influence in Washington. As always, we will be a counterweight to the immense economic and political power used by some in the financial industry and their allies to sabotage *meaningful* reforms to our securities markets.
