To: Interested Parties

Subject: ***<u>Key Topics for GameStop, Robinhood, Citadel, Reddit, Roaring Kitty Hearing at the House Financial Services Committee</u>***

Date of Hearing: Thursday, February 18, 2021 at 12PM

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<u>Introduction</u>

This memo is being released in advance of the House Financial Services Committee hearing "Game Stopped? Who Wins and Loses When Short Sellers, Social Media and Retail Investors Collide?" on Thursday, February 18, 2021 at 12PM. Below is information on the key issues that should be discussed at that hearing and at the end are links to additional materials that provide greater detail.

ADDITIONAL MATERIALS

Better Markets' Press Release: https://bettermarkets.com/newsroom/better-markets-letter-house-financial-services-committee-key-issues-thursday-s-hearing

Link to Better Markets' Letter to House Financial Services Committee regarding the hearing: https://bettermarkets.com/sites/default/files/Critical%20Issues%20to%20Adress%20in%20the%20Game%20Stop%20Hearing.pdf

Fact Sheet on Payment for Order Flow/Conflicts of Interest/Best Execution: https://bettermarkets.com/sites/default/files/documents/Better_Markets_Payment_for_Order_Flow_Long_02-21-2021.pdf

Fact Sheet on Citadel:
https://bettermarkets.com/sites/default/files/documents/Better_Markets_Citadel_Role_in_GameStop_02-16-2021.pdf

Index to Better Markets' key materials on these and related critical issues:
https://bettermarkets.com/resources/better-markets-work-market-structure

FACTUAL BACKGROUND

1. Real people lost billions of dollars in GameStop trading

Real people lost billions of dollars trading GameStop stock and options. It was not just Wall Street hedge funds short selling stock who incurred losses. For example, according to recent polling, 28% of Americans bought GameStop or other viral stocks in January 2021, with 8% investing over $5,000, driving the average investment to $8,533.[1] GameStop's share price rocketed up as much as 1,700% in the month of January,[2] but as of February 12, 2021, it had crashed more than 90% below its peak, reportedly wiping away over $20 billion in investments.[3]

2. GameStop Trading was not justified by any fundamental analysis of GameStop's business

The price movements in GameStop stock were completely divorced from any fundamental analysis of GameStop's business. A rudimentary review of GameStop's financial and business prospects (before the meteoric rise of the stock price) would have yielded the following unmistakable conclusions: GameStop was bleeding revenue in 2019 and 2020;[4] it was closing stores with little to no prospects of re-opening them (even before the COVID-19 pandemic kept people away from shopping malls where many of GameStop's stores are located); and its most basic business—that of selling and renting hard-disk video games—was under threat from the new generation video game consoles that were no longer equipped with hard-disk readers and instead required gamers to digitally download or stream the games. Yet, none of this prevented millions of investors who were hyped, misled, or manipulated into pouring their hard-earned money into GameStop and similar stocks. And none of this seems to have mattered to Robinhood (and others) who peddled, facilitated, and enabled leveraged and margin investing that some now believe has become so widespread as to have systemic risk implications.[5]

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1 See E. Wolff-Mann, 28% of Americans Bought GameStop Or Other Viral Stocks in January: Yahoo Finance-Harris Poll, Yahoo! Finance (Feb 9, 2021), *available* at https://finance.yahoo.com/news/gamestop-amc-reddit-investing-213609595.html.

2 See N. Popper, Reddit's 'Roaring Kitty' Will Speak At GameStop Hearing, New York Times (Feb 12, 2021), *available* at https://www.nytimes.com/2021/02/12/business/gamestop-hearing-roaring-kitty.html.

3 See W. Daniel, GameStop Has Lost Over $20 Billion In Market Capt Since The Reddit-saga Peak, Business Insider (Feb. 9, 2021), *available* at https://markets.businessinsider.com/news/stocks/gamestop-stock-lost-billions-market-cap-reddit-saga-peak-2021-2-1030062086.

4 See O. Kharif, GameStop Falls Most in 15 Months on Sluggish Sales, Stock Offer, Bloomberg (Dec 8, 2020), *available* at https://www.bloomberg.com/news/articles/2020-12-08/gamestop-declines-after-sales-fall-more-than-analysts-estimated.

5 See P. Jenkins, Are leveraged Gen Z Traders The Next Systemic Risk? Financial Times (Feb. 14, 2021), *available* at https://www.ft.com/content/ff39c4b7-401d-4b03-8d7b-48e7fbc25237?shareType=nongift.

OVERARCHING THRESHOLD ISSUES

3. The GameStop frenzy was a near-miss, not evidence of resilience.

Any examination of the issues raised by GameStop should not overemphasize the apparent resiliency of our financial markets' *infrastructure*. Two weeks ago, Treasury Secretary Yellen and the chairs or heads of several U.S. financial regulators, including the SEC, assembled to discuss GameStop trading and related events. The Treasury Department subsequently released a statement that U.S. regulators "believe the core infrastructure was resilient during high volatility and heavy trading volume,"[6] mirroring comments made by some participants in the lead-up to the meeting. Although clearinghouses, for example, thus far have performed well and apparently responsibly, the Committee should not let that fact distract from the many areas of our financial markets that either did not perform well or should have performed better. Furthermore, regulatory shortcomings in numerous areas that gave rise to troubling practices at the center of the GameStop events must be remedied by long understood—and equally long overdue—reforms (discussed below), even if those reforms relate to activities *within* a financial markets infrastructure that is not impaired.

Undue attention to the lack of an infrastructure meltdown also would seem to underemphasize how perilously close Robinhood came to instigating a seriously adverse market event. After drawing on six bank credit lines reportedly totaling as much as $600 million, Robinhood reportedly sought an emergency infusion of more than $3.4 billion over four days to prevent further disruptions to trading on the platform.[7] In more extreme (but plausible) market conditions, Robinhood may have had more difficulty drawing on its credit lines and/or raising such a significant amount of capital on an emergency basis,[8] particularly at a time when other large market participants were dire need of substantial additional capital, like the $2.75 billion bailout of Melvin Capital.[9] If Robinhood defaulted on its margin calls, it could have been forced to more

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6 See J. Smialek, D. Solomon, Yellen and Regulators Met Amid GameStop Frenzy to Discuss Market Volatility, New York Times (Feb. 24, 2021), *available* at https://www.nytimes.com/2021/02/04/business/economy/yellen-gamestop.html.

7 See M. Kruppa et al., Robinhood raises $2.4bn in second cash injection in four days, Financial Times (Feb. 1, 2021), *available* at https://www.ft.com/content/790324e0-8526-4d9e-9717-a4430e1be034; see also K. Kelly, E. Griffith et al., Robinhood, in Need of Cash, Raises $1 Billion From Its Investors, New York Times (Jan. 29, 2021), *available* at https://www.nytimes.com/2021/01/29/technology/robinhood-fundraising.html.

8 There are also a number of questions regarding the investors in Robinhood, as pointed out by Gillian Tett in the Financial Times, *available* at https://www.ft.com/content/72aa45ee-4591-4819-a104-9d445d3f4daf?shareType=nongift

9 Imagine the potential challenges of Robinhood trying to raise $4 billion if, rather than just Melvin Capital, multiple hedge funds and other market participants had experienced correlated losses and each sought a $2.75 billion emergency bailout. That scenario is highly plausible given that Melvin Capital Management alone reportedly declined more than 50% in the month of January due to losses on its GameStop short positions. See Juliet Chung, Citadel, Point72 to Invest $2.75 Billion Into Melvin Capital Management, Wall Street Journal (Jan. 25, 2021), *available* at https://www.wsj.com/articles/citadel-point72-to-invest-2-75-billion-into-melvin-capital-management-11611604340.

broadly halt trading and/or unexpectedly close-out the most volatile positions across as many as 13 million retail accounts, thereby exposing every holder of securities affected by these actions to potentially dramatic changes in prices, liquidity, and order flow.

Similarly, if the hedge fund Melvin Capital were not able to obtain emergency funds and/or had to close out and/or cover all of its GameStop and other positions—or had to simply default on some of those positions—the fire sales and knock-on liquidity demands might have ignited a panic. This scenario brings to mind the apparently forgotten lessons of Long Term Capital Management.[10]

Thus, any analysis of these issues should focus on and emphasize the fact that the GameStop trading events were an apparent *near-miss*, not necessarily a demonstration that our infrastructure *would have* remained resilient under highly plausible, slightly more adverse circumstances.

4. Some characteristics of the recent market turmoil may be new, but the underlying trading practices, abuses, and market vulnerabilities are not.

The frenzied trading in so-called "meme stocks"—apparently almost entirely unrelated to fundamental analysis—and "Reddit Rebellion" securities has appeal as "new" issues and practices. However, there is little new about irrational exuberance and speculative fervor for questionable securities, and frankly, there is little new about most of the other issues raised by the GameStop trading events. Market participants at the center of these events have for years taken advantage of market fragmentation, order routing schemes, questionable execution practices, and leveraged trading strategies. And even in the current saga, there are reports that some sophisticated participants made hundreds of millions of dollars momentum trading (exacerbating volatility both as the price went up and as it crashed).[11] And yet, for years, the financial regulators have failed to fully and properly examine, much less remedy and responsibly limit, these questionable if not abusive, predatory or illegal practices.

Furthermore, for years, a handful of Wall Street's biggest banks have "danced while the music was playing."[12] They have facilitated many of the trading practices at the center of the

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[10] See S. Yang, The Epic Story of How a 'Genius' Hedge Fund Almost Caused a Global Financial Meltdown, Business Insider (Jul 10, 2014), *available* at https://www.businessinsider.com/the-fall-of-long-term-capital-management-2014-7.

[11] See J. Chung, This Hedge Fund Made $700 Million on GameStop, Wall Street Journal (Feb. 3, 2021), *available* at https://www.wsj.com/articles/this-hedge-fund-made-700-million-on-gamestop-11612390687.

[12] See Ex-Citi CEO Defends "dancing" to U.S. Panel, Reuters (Apr. 8, 2010), *available* at https://www.reuters.com/article/financial-crisis-dancing/ex-citi-ceo-defends-dancing-quote-to-u-s-panel-idUSN0819810820100408; see also D. Kelleher, Remarks on Stress Tests as a Policy Tool: No Evil Required, Conference on "Stress Testing: A Discussion and Review," pp. 10-11 (July 9, 2019), *available* at https://www.bostonfed.org/-/media/Documents/events/2019/stress-testing/stress-tests-and-policy-paper-kelleher.pdf?la=en.

events and bent the rules of the markets to their advantage using their roles in the governance, operation, and resiliency of clearinghouses, exchanges and trading venues, data repositories, and more. Those banks also remain (a) the prime brokers for most sizable hedge funds, including those involved in the GameStop events; (b) the dominant derivatives dealers with 87.3% of U.S. derivatives exposures;[13] and (c) significant lenders in various capacities, including as securities lenders.

The particular *context* for these events may be new, but most of the issues, trading practices, and obvious vulnerabilities of the U.S. financial system are not.

5. Notwithstanding the need for re-examination and reforms, existing laws can and must be brought to bear against any unlawful conduct.

Although the vehicles, methods, and means for violating the law change, our financial regulators' duties to protect investors and market integrity remain timeless and paramount. Today's laws must be evaluated for the appropriateness of their scope and application (as discussed below), but the Committee also should remind U.S. regulators, if necessary—and most especially the SEC and FINRA—that they have extensive authority and resources and a duty to address any violations of law, including manipulation and fraud in connection with or related to the recent frenzied trading in GameStop and beyond. Fraud, market manipulation, and other illegal practices are punishable regardless of forum or form and should be charged as such regardless of whether they occur at an open-outcry tulip auction or via a cool app or subreddit channel.

AREAS FOR CONGRESSIONAL INQUIRY

6. Gamification of Trading

Robinhood appears to have perfected the "gamification" of trading by incorporating 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.[14] Thus, Robinhood has taken 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 attributes. Needless to say, investing in markets is not a game but involves the gaining and losing of often life-changing sums of money, often in a very short period of time.

The concerns regarding the gamification of trading are not limited to protecting individual investors, however important that may be. Manic, panicky, frenzied, and, at times, irrational investing,

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13 See Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities: Third Quarter 2020 (Dec. 2020), *available* at https://www.occ.gov/publications-and-resources/publications/quarterly-report-on-bank-trading-and-derivatives-activities/files/pub-derivatives-quarterly-qtr3-2020.pdf.

14 Interestingly, it appears that the mere use of a smartphone itself increases trading activity generally and trading in so-called "lottery stocks" in particular. See, https://www.marketwatch.com/story/heres-another-explanation-for-the-surge-in-speculative-activity-smartphones-11611579511 citing an NBER study *available* here https://www.nber.org/system/files/working_papers/w28363/w28363.pdf

particularly at scale, have effects that reach far beyond the individual investors involved and can adversely impact, among other things, price discovery, company valuations, capital allocation, and capital formation. It can even implicate market and systemic stability.

Particularly in light of the leveraged retail trading that may have been occurring at scale in GameStop and other equities,[15] the Committee should explore the following:

- Whether Robinhood and other retail broker-dealers have been doing enough to satisfy existing legal duties before enabling extensive, leveraged trading, and whether the standards for enabling high-risk trading strategies should be revised and strengthened;

- Whether the design features of trading apps should be regulated—as are certain retail-investor disclosures today—to maximize investor protection and investor empowerment;[16] and

- Whether retail 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.

These issues 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.

7. Forced Arbitration

Dozens of lawsuits have already been filed in connection with the recent market turmoil and extensive trading losses. For example, claimants allege that Robinhood's decision to shut down purchases of GameStop shares during a critical period of time violated its contracts with clients, its fiduciary duty, and/or applicable laws and rules. Presumably, Robinhood and other defendants will invoke their lengthy, fine-print customer agreements and insist that all individual lawsuits against them must be dismissed and heard not in court but before an arbitration forum such as the one operated by the brokerage industry under FINRA's auspices.[17] Yet, it is well-established that arbitration is a biased forum that favors industry respondents and affords wronged investors very little meaningful relief.[18] Moreover, it is highly secretive, providing neither the public nor regulators any insight into the nature of the claims

15 See P. Jenkins, Are leveraged Gen Z Traders The Next Systemic Risk? Financial Times (Feb. 14, 2021), *available* at https://www.ft.com/content/ff39c4b7-401d-4b03-8d7b-48e7fbc25237?shareType=nongift.

16 It has been suggested that Robinhood, for example, designed its app to make it difficult to enter a limit order compared to, for example, a market order. Also, reports indicate that buying puts and calls on Robinhood is an exciting and easy activity. These design features and others like them can be used to maximize revenues at the expense of investor protection and empowerment.

17 See Robinhood Financial LLC & Robinhood Securities, LLC Customer Agreement, Section 38 Arbitration (Revised June 22, 2020), *available at* https://cdn.robinhood.com/assets/robinhood/legal/Customer%20Agreement.pdf.

18 See, generally, Forced Arbitration: Taking Away Your Rights and Your Money, Better Markets (June 11, 2019), *available* at https://bettermarkets.com/blog/forced-arbitration-taking-away-your-rights-and-your-money.

being lodged or the manner in which they are resolved. And it lacks the procedural protections provided in court proceedings, including the right to appeal an erroneous decision or to even have a written decision stating the facts found and the basis for the decision.

Accordingly, these recent events represent yet another occasion for examining the pressing need to ban or limit mandatory pre-dispute arbitration clauses in financial services agreements. In this and other appropriate hearings, the Committee should address these questions:

- In general, whether and to what extent market participants should be permitted to use and rely upon mandatory pre-dispute arbitration clauses in their client agreements; More specifically, whether and to what extent they doing so in response to the claims now being advanced in court in connection with the GameStop trading turmoil;

- Whether and to what extent forced arbitration proceedings result in (1) injured investors receiving compensation and in what amounts, (2) financial firms pocketing ill-gotten gains because investors are not able to fully recover their losses from illegal conduct, and (3) regulators and legislators being deprived of information regarding the illegal conduct of financial firms due to the non-public secret nature of the proceedings and the complete lack of procedural protections, including but not limited to written decisions with factual findings from the record that support an articulated basis for the outcome;

- Whether carve-outs under applicable rules for class action lawsuits really provide injured investors with an adequate and practical means of obtaining relief; and

- Whether the SEC failed to use the explicit authority it received in Section 921 of the Dodd-Frank Act to prohibit or limit the use of mandatory arbitration clauses in agreements between brokers and their clients.

8. Payment for Order Flow/Conflicts of Interest

Many retail broker-dealers offer "commission-free trading," while routing customer orders to executing dealers for internalization or execution in market centers. The practice of retail 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 ("NBBO") apparently occurs with some frequency, a multi-billion dollar "hidden tax" on execution of retail customer orders is apparently exacted with some frequency as well[19]—in part due to predatory if not

[19] The PFOF for stock and options orders across the largest retail broker-dealers totaled approximately $2.6 billion in 2020. See A. Osipovich, GameStop Mania Drives Scrutiny of Payments to Online Brokers, Wall Street Journal (Feb. 4, 2021), *available* at https://www.wsj.com/articles/gamestop-mania-drives-scrutiny-of-payments-to-online-brokers-11612434601. Given longstanding and well known industry practices and behaviors, there is no doubt that HFTs paid billions to secure that order flow to generate revenues presumably of at least the amount paid (i.e., it would be reasonable to assume that the HFTs are netting at least $2.6 billion a year from that order flow). Thus, the question is not whether the HFTs make money from Robinhood and similar retail broker-dealers' order flow—they do!—but whether the means by which they make such money results in retail customers getting worse pricing for that trading. The SEC is in a unique position to do a data-driven study and answer that question definitively and Congressional oversight committees should demand that they do so ASAP and release their report publicly. Importantly, that question is in addition to whether or not such practices and costs have been fully and fairly disclosed and whether or not a reasonable investor would understand such disclosures.

illegal behavior, but also because of a lack of clarity in the best-execution standard intended to mitigate such conflicts. These execution costs can outweigh the benefits to retail investors associated with so-called "commission-free trading."[20]

Given that the conflicts of interest and misaligned incentives that fuel PFOF cannot be mitigated to adequately protect investors, the Committee should explore legislative solutions that would prohibit the practice of PFOF. In connection with that legislative process, the Committee should ask regulators (including but not limited to the SEC and the Office of Financial Research (OFR)) to undertake a study of the following and to submit a public report to the Committee detailing all findings and data:

- 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;

- 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;

- Whether execution quality increased subsequent to prohibitions on PFOF in other jurisdictions;

- 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;

- Whether retail broker-dealers, including Robinhood, receive higher rebates for certain types of orders and financial instruments, and whether broker-dealers promote more profitable order types and financial instruments to a greater degree than other types of orders and financial instruments, all to the detriment of retail investors;

- Whether smart order routers of retail broker-dealers should be permitted to discriminate against executing dealers and trading venues that do not provide such retail broker-dealers PFOF;

- Whether executing dealers providing PFOF to retail broker-dealers should be (1) prohibited from internalizing trades at the NBBO and (2) required to internalize only at a material price improvement to the NBBO; and

- Whether in addition to a prohibition on PFOF, retail order flow should be required to be routed to the exchanges in lieu of internalization and if so, whether other regulatory changes would need to accompany such a rule to protect investors (e.g., regulatory standards for exchange fees, rebate programs, and order execution protocols).

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20 In addition, legislators and regulators need to analyze the impact of broker claims of "commission-free trading," which are too often heard and understood by a reasonable investor as "free trading." Put differently, claims of "commission-free trading," without more, may be materially misleading to a reasonable investor and, if so, the SEC should stop them.

9. Issues Regarding Short Selling

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 metrics do not adequately capture the levels of short interest in a timely fashion. Moreover, these measures understate the short interest acquired through derivatives, including cash-settled derivatives, that provide leveraged exposures to securities, or baskets of securities, without any purchase or sale of the underlying securities.

The Committee must exercise its full oversight and legislative functions to investigate and explore reforms (both in the February 18th and subsequent hearings) in the following areas of concern:

- Whether any of the witnesses, the companies they lead, or their affiliated companies or persons played a role in shorting, or facilitating or enabling or promoting the shorting, of GameStop or similar "meme" stocks, and if so, what role did they play?
- Whether the SEC should increase the frequency and expand the scope of short interest reporting by broker-dealers and impose reporting obligations by other market participants;
- 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, as well as other filings, such as the Form 13F used by institutional investment managers;
- Whether regulators and market participants have access to timely and complete information on short interest, including short interest acquired through equity derivatives; and
- Whether short-selling restrictions should be effected on an investor-by-investor, broker-dealer-by-broker dealer, or other basis beyond a certain ratio of the number of shorted securities to the total float in that security.

10. Manipulation

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 SEC and CFTC 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 retail momentum and pushed up prices as well. On the other side of the market, the GameStop short interest held by hedge funds and others that reportedly served as motivation for the so-called "Reddit Rebellion's" trading rose as high as 100% of the free float (i.e., total stock available to trade) in 2019 and 2020 and exploded as GameStop's price continued to increase in 2021. The short interest, at its peak, reportedly exceeded the total stock available to trade by a fairly significant amount and may have reached as high as 140% of the total float.

Some of the critical questions with respect to manipulation include the following:

- Whether some class of retail investors demonstrably intended to engage in manipulative trading practices to effect a short squeeze;

- Whether retail investors actually caused the short squeeze in GameStop, as frequently reported, or whether other trading interests took advantage of retail trading momentum and/or withdrew liquidity to exacerbate or cause the upward price pressures;

- Whether institutional investors or others were engaged in manipulative practices, including through automated trading on incoming retail customer orders or their extensive short selling in equities;[21]

- Whether certain traders or public persons who were publicly encouraging purchase or retention of GameStop and other equities were simultaneously selling to secure profits or limit losses;

- Whether any broker-dealer trading halts (i.e., limitations on solely buy or sell orders) were implemented to benefit certain positions in affected securities; and

- Whether definitions and prohibitions on market manipulation and manipulative trading practices in statutes as well as SEC and CFTC regulations and interpretations fully cover the range of practices and activities that were detrimental to retail traders.

11. Best Execution

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

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[21] This should include the reported and suspected jump in bot and imposter activity on the WallStreetBets subreddit. See, Sean Murray, GameStop Stock Price Falls As Bots Invade WallStreetBets, TheGamer (Feb. 2, 2021), *available* at https://www.thegamer.com/gamestop-stock-bots-wallstreetbets/; Stephen Gandel, WallStreetBets says Reddit group hit by 'large amount' of bot activity, CBS News (Feb. 2, 2021) *available* at https://www.cbsnews.com/news/wallstreetbets-reddit-bot-activity/; and, Caitlin McCabe, A Week Inside the WallStreetBets Forum That Launched the GameStop Frenzy, Wall Street Journal (Feb. 13, 2021), *available* at https://www.wsj.com/articles/a-week-inside-the-wallstreetbets-forum-that-launched-the-gamestop-frenzy-11613212202?mod=series_gamestopstockmarket.

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.[22]

The Committee should convene an oversight hearing in connection with enforcement of existing rules and explore additional pro-investor and pro-market integrity reforms in the following areas:

- Whether the SEC and the FINRA have sufficient order routing and execution visibility to permit comparisons of execution quality and ensure compliance with the best-execution standard;
- Whether SEC and FINRA regulations and guidance requiring regular and rigorous execution quality reviews by retail and executing broker-dealers sufficiently protect investors, and whether trade-by-trade analyses and testing programs should be required for many, if not all, orders routed and executed on an automated basis;
- 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;
- Whether the multi-factor best execution standard is appropriately enforceable; and
- Whether so-called "price improvement" metrics should benchmark against the national best bid or offer ("NBBO"), given the prevalence of internalization and the exclusion of significant order flow (e.g., "odd-lot" order flow) from the NBBO at this time.

12. Capital and Liquidity Requirements

In the course of intense public scrutiny of events surrounding GameStop and other equities, Robinhood (and other retail-focused brokers) apparently enacted ad hoc trading halts on the purchase of a number of volatile securities (with certain exceptions), including GameStop,[23] which apparently advantaged short positions in the market. In doing so, Robinhood reportedly gave different explanations at different times, and sometimes gave conflicting explanations at the same time. The company's most plausible explanation was that the trading halts, in essence, were defensive measures intended to protect against unspecified financial requirements arising from the volatility in certain securities and its clearing agencies' own protective measures.

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[22] See SEC, In Re Robinhood Financial, Order Instituting Administrative and Cease and Desist Proceedings (Dec. 17, 2020) *available* at https://www.sec.gov/litigation/admin/2020/33-10906.pdf (finding that "Robinhood had conducted a[n] . . . extensive internal analysis that found Robinhood's execution quality and price improvement metrics were substantially worse than other retail broker-dealers' in many respects, and [that] senior Robinhood personnel were aware of this analysis" and further finding that Robinhood executives knew that "the percentage of orders that received price improvement and the amount of price improvement, measured on a per order, per share, and per dollar traded basis" were "substantially worse than other broker-dealers").

[23] See M. Fitzgerald, Robinhood Restricts Trading in GameStop, Other Names Involved In Frenzy, CNBC (Jan 28, 2021), *available* at https://www.cnbc.com/2021/01/28/robinhood-interactive-brokers-restrict-trading-in-gamestop-s.html.

The Committee should explore the apparent inconsistencies in the statements of Robinhood's executives in the aftermath of its trading halt. For example, apparently as or shortly before it sought a $3.4 billion capital infusion, Robinhood's chief executive officer ("CEO") claimed on CNBC that "[t]here was no liquidity problem" on account of clearinghouse margin calls, that Robinhood draws down its credit lines "all the time," and that the firm's trading halts were being done "preemptively" and "proactively."[24] Yet, Robinhood's CEO suggested during the same interview that its trading halts were motivated by the substantial deposits due to clearinghouses on account of market volatility and its customers' concentrated positions, as well as unspecified impacts on its net capital position.[25] If Robinhood was in financial distress or came perilously close to defaulting on its margin calls, the facts and timelines surrounding its $3 billion margin call, $3.4 billion in emergency fundraising,[26] imposition of the trading halt, and related events would be highly relevant to the Committee's consideration of the adequacy of retail broker-dealer capital and liquidity requirements (separate and apart from regulators' and prosecutors' interest in whether or not any of these statements were fraudulent or misleading).

In this regard, the Committee should explore the following areas of concern:

- 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;

- Whether Robinhood, specifically, experienced liquidity shortfalls or other financial distresses, and the nature of the exact causes or drivers of such shortfalls and/or distresses;

- Whether Robinhood, specifically, and broker-dealers in general have written policies, procedures, and controls to govern determinations to impose trading halts; whether trading halts are required to be integrated into risk management programs; and whether asymmetric trading halts should be permitted at all;

- Whether Robinhood had any undisclosed financial motives for imposing an asymmetric trading halt;

- Whether any trading halts by retail broker-dealers should be affected only after a public notice period has expired;

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24 K. Stankiewicz, Robinhood CEO: Tapping credit lines is proactive, not a sign of cash crunch in GameStop frenzy, CNBC (Jan. 29, 2021), *available* at https://www.cnbc.com/2021/01/29/robinhood-ceo-vlad-tenev-tapping-credit-lines-proactive-to-help-lift-gamestop-trading-limits.html.

25 Id.

26 We note that investors in the Robinhood fundraising round four days after the initial emergency $1 billion capital infusion reportedly accepted terms that were "less favourable" than the first round, suggesting that Robinhood had an immediate need to close on the initial round of investment following the initial National Securities Clearing Corporation's margin call. See M. Kruppa, Robinhood's bid to 'democratise finance' collides with Wall St reality, Financial Times (Feb. 1, 2021), *available* at https://www.ft.com/content/9e69faf0-09c4-42ca-8c5f-78dc9568c18f.

- Whether broker-dealer trading halts and exchange trading halts or circuit breakers should be coordinated on securities experiencing extraordinary volatility or unusual trading (e.g., through an early warning notice published by the exchanges); and

- Whether exchange trading-halt or circuit-breaker standards should permit cessation of trading in equities experiencing frenzied or mania-driven trading that is obviously divorced from fundamentals.

13. Consolidated Audit Trail

The SEC must have access to timely, accurate, and complete information on trading activities across markets to effectively supervise and police markets as well as to consider policy improvements in light of trading activities, developments and anomalies, such as those we witnessed in recent weeks. This common sense proposition has been understood since at least the "Flash Crash" in May 2010, after which the SEC commenced plans to create a consolidated audit trail ("CAT") on all trading-related activities in the securities markets. Once fully operationalized—with needed upgrades and appropriate oversight—the CAT will collect 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.

The Committee should hold the SEC and industry-led consortium, CAT NMS, accountable for its years-long failure to operationalize the CAT. In this regard, the Committee should hold an oversight hearing and explore the following areas of concern:

- 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;

- Whether the SEC 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 long overdue project;

- Whether transparent CAT-planning milestones and significant penalties can be adopted near-term to increase accountability and the rapid construction, deployment, and operation of the CAT;

- Whether recent changes to the CAT NMS Rule would make it more difficult for regulators to detect manipulative trading activities and identify manipulators—and make CAT less user-friendly—by (1) reducing or eliminating key information to be reported into CAT and (2) increasing hurdles (such as download and access limits) for users;

- Whether accelerated phased implementation of certain order and trade execution information would better facilitate near-term completion of the CAT; and

- Whether the SEC should upgrade CAT with an eye towards real-time reporting as originally envisioned by the SEC in 2010.