BETTER MARKETS

– FACT SHEET –

Better Markets' Views on the Key Issues Raised at the House Financial Services Committee Hearing on February 18, 2021

February 26, 2021

Game Stopped? Who Wins and Loses When Short Seller, Social Media and Retail Investors Collide

The House Financial Services Committee's hearing on the events and causes related to the GameStop trading frenzy shined a bright light on how today's capital markets work, who they favor, and who is not well served by them. Sadly, it revealed how little information about today's markets is publicly disclosed or known. Indeed, it revealed that elected officials are dependent on profit maximizing insiders to reveal the most import information about not only how the markets work, but how capital is allocated, how investors are treated, and how resilient the financial system is or is not.

With the objective of eliciting as much information as possible, the Chair and many Committee Members asked important questions essential to understand those events and, ultimately, determine whether or not the laws, rules and regulations were followed or might need to be changed. However, Chairwoman Maxine Waters opened the hearing with the key observation: "Americans feel the system is stacked against them, and no matter what, Wall Street always wins."

That sentiment was echoed throughout the hearing. Several Members of the Committee further observed that the GameStop trading frenzy and related events—and the fragilities they exposed—are the predictable symptoms of a financial ecosystem that seems to favor a few powerful Wall Street firms over the many Main Street savers and investors. Chairwoman Waters also rightly acknowledged that responding to the visible symptoms of a dysfunctional market structure is a necessary first step, but that a series of hearings and actions examining and responding to the deeper, less visible, structural issues will be imperative if investors are to be protected and markets are to serve society.

In this post-hearing recap, we will briefly discuss several of the key issues: gamification of investing; payment for order flow (PFOF); forced arbitration; short-selling; capital requirements for brokers; and settlement cycles.[1] In addition to this recap, we are also releasing a montage of key moments of the nearly 5 hours hearing featuring Chair Maxine Waters, AOC, Jim Himes, Ritchie Torres, Al Green, Cindy Axne, Rashida Tlaib, and Jesus "Chuy" Garcia.

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[1] For more detailed information about these subjects, refer to our letter to the House Financial Services Committee regarding the critical issues to address at the GameStop hearing, available at https://bettermarkets.com/sites/default/files/Critical%20Issues%20to%20Adress%20in%20the%20Game%20Stop%20Hearing.pdf, see also Better Markets' Fact Sheet on Payment for Order Flow, available at https://bettermarkets.com/sites/default/files/documents/Better_Markets_Payment_for_Order_Flow_Long_02-21-2021.pdf; Better Markets Fact Sheet on Citadel Securities and GameStop, available at https://bettermarkets.com/sites/default/files/documents/Better_Markets_Citadel_Role_in_GameStop_02-16-2021.pdf; and Better Markets' Fact Sheet on the Consolidated Audit Trail, available at https://bettermarkets.com/sites/default/files/documents/Better_Markets_CAT_Fact_Sheet_02-16-2021.pdf

Gamification of Investing

The hearing validated the policymakers' and investor advocates' concerns that gamification of investing has become a public policy challenge. 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. During one notable exchange, Robinhood's CEO spoke approvingly about a feature of Robinhood's app that triggered users to open the app upwards of a thousand times a day: Robinhood's CEO said he wanted the app to "delight" its users. Members saw it differently, calling it a harmful addiction and drawing attention to the fact that Robinhood's business model is more profitable as trading increases.

Trivializing financial decisions and downplaying the costs and risks—especially emotionally and intuitively—greatly benefits intermediaries like Robinhood. It converts a somber decision—that of investing and risking money—that has historically been viewed as requiring thought, diligence, analysis, and financial wherewithal into a thoughtless, rapid, but revenue-generating activity. Manic, panicky, frenzied, and, at times, irrational investing—all enabled and promoted by Robinhood—could 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.

This is not the "democratization of trading" as much as it is a mechanism to drive up the profits of retail brokers like Robinhood. It is clear that a number of Members agree that, while enabling more people to trade more easily via a better "user experience" is important, it must not be used to subliminally disarm retail investors to the costs and risks of trading.

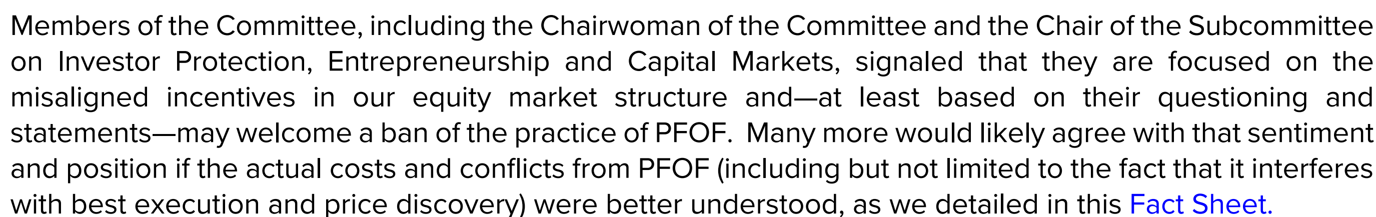
Payment for Order Flow and Best Execution

The hearing brought much attention to the legalized kickback scheme that underpins much of today's "commission free" trading (which far too many retail investors incorrectly understand to mean "free trading"). Instead of seeking the best reasonably available price for their traders' orders, retail brokers like Robinhood are incentivized to chase kickbacks that generate billions of dollars of revenue, known as payments-for-order-flow (PFOF).

This kickback scheme results in unmanageable conflicts of interest and imposes a multi-billion-dollar-a-year hidden tax on investors and retirees who do not actively trade. Several Members expressed concerns and agreed that these conflicts of interest and misaligned incentives that fuel PFOF cannot be mitigated to adequately protect investors. In one striking exchange, Citadel's CEO all but confirmed that Citadel Securities, in executing two identical orders but from two different broker-dealers, discriminates on timing and perhaps price, depending on whether Citadel pays a broker-dealer a kickback as part of a PFOF arrangement.

Interestingly, Citadel's CEO essentially stated that his firm would adapt its business model to whatever regulatory framework provided by the SEC, even if that framework prohibited PFOF and similar kickback schemes:

> "With respect to payment for order flow, we simply play by the rules of the road. Payment for order flow has been expressly approved by the SEC. It is a customary practice within the industry. If they choose to change the rules of the road, we need to drive on the left side versus the right side, that's fine with us".



Members of the Committee, including the Chairwoman of the Committee and the Chair of the Subcommittee on Investor Protection, Entrepreneurship and Capital Markets, signaled that they are focused on the misaligned incentives in our equity market structure and—at least based on their questioning and statements—may welcome a ban of the practice of PFOF. Many more would likely agree with that sentiment and position if the actual costs and conflicts from PFOF (including but not limited to the fact that it interferes with best execution and price discovery) were better understood, as we detailed in this Fact Sheet.

Lack of Client Service and Forced Arbitration

The hearing shed light on Robinhood's inexcusably bad customer service record. In one memorable exchange, a Member of the Committee dialed Robinhood's customer-service telephone number, only to be told by the automated telephone prompt that Robinhood's customer service is only available via email.

In another exchange, Robinhood's CEO confirmed Robinhood's practice of forcing its clients to attempt to resolve their disputes in a forced arbitration setting. It is well-established that arbitration is a biased forum that favors industry respondents and affords wronged investors very little meaningful relief. Moreover, it is highly secretive, providing neither the public nor regulators any insight into the nature of the claims 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. No one who truly cares about their customers would force them to give up their most important legal rights and force them into dark, biased proceedings where the customer almost always loses.

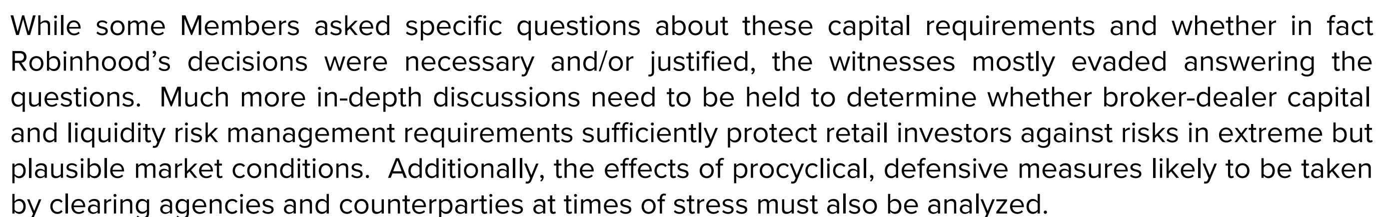
Short-Selling

By many accounts, lack of disclosure of short positions and excessive short-selling of GameStop stock played a causal role in the trading frenzy and related events. Some retail traders on r/WallStreetBets decided to punish a hedge fund that held large short positions in GameStop by purchasing, in seemingly coordinated fashion, both long-positions and options that pushed the price of GameStop stock higher. That, in turn, resulted in substantial losses to short positions and forced hedge funds, including Melvin Capital Management, to cover their short positions through the purchase of GameStop stock, which pushed the price higher still.

A number of Members of the Committee asked some of the witnesses whether more disclosures about short positions would have helped retail traders to make more informed decisions. They also raised concerns about reports that GameStop's stock was shorted over 100% of the available float through practices like re-shorting, which is essentially lending already borrowed stock to new borrowers. The practice of re-shorting may have resulted in significant disruptions to the settlement process on certain trading days.

Capital Requirements for Brokers

The hearing highlighted the capital and liquidity regulatory requirements imposed on brokers. Robinhood repeated its claims that it halted purchases but not sales of GameStop stock (*i.e.*, permitted liquidation only) to comply with margin calls and capital requirements. Robinhood also reiterated that at no time was its broker out of compliance with applicable rules and laws. None of those answers, however, detailed the procedures followed, or the decisions made regarding any of that, including in particular the decision to halt buying but not selling GameStop stock, which favored the short sellers and other market participants to the disadvantage of Robinhood's customers.



While some Members asked specific questions about these capital requirements and whether in fact Robinhood's decisions were necessary and/or justified, the witnesses mostly evaded answering the questions. Much more in-depth discussions need to be held to determine whether broker-dealer capital and liquidity risk management requirements sufficiently protect retail investors against risks in extreme but plausible market conditions. Additionally, the effects of procyclical, defensive measures likely to be taken by clearing agencies and counterparties at times of stress must also be analyzed.

Settlement Cycles

As telegraphed prior to the hearing, some of the witnesses called for shortening the settlement period from the current T+2 (*i.e.*, the trade date, plus two additional business days) to T+1 (*i.e.*, the trade date, plus one additional business day). Some even appeared to support same-day settlement of trades.

Shortening the settlement cycle can reduce risks to the clearing system and therefore reduce margin calls and capital buffers necessary to support securities trading. Shortening the settlement cycle undoubtedly would benefit retail investors by reducing capital and liquidity necessary for broker-dealers to support any given level of trading through their platforms and allow investors to have quicker access to funds and securities following trade execution. Those lower financing, capital, and liquidity costs may benefit investors. However, while moving to T+1 appears to make sense, there needs to be careful analysis of same-day settlement to ensure that investors benefit.

Conclusion

We applaud the Chair for holding this hearing and the Members for doing the best they could given the time limitations, the format, and the witnesses' proclivity for evading tough questions. We look forward to the Committee's future hearings on these matters, particularly one that examines the knowledge, actions and tools of the market and banking regulators.

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Better Markets fights for the economic security, opportunity and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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