Securities Regulation Daily Wrap Up, TOP STORY—Gensler presents case for review of equity markets regulations, (Jun. 10, 2021)

Securities Regulation Daily Wrap Up

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By Mark S. Nelson, J.D.

The SEC appears set to review rules for best execution and other emerging equity markets issues such as gamification.

In his second substantive remarks in four days, SEC Chair Gary Gensler turned to a topic with which he has lots of experience—market structure. As Chair of the CFTC, Gensler stood up for the agency's derivatives and swaps reforms under the Dodd-Frank Act. Now, as SEC chair, Gensler said in a speech to the Global Exchange and FinTech Conference that he is looking to Commission staff to make recommendations on equity market structure that could lead to rules changes on a range of issues, including the competitiveness of equity markets, payment for order flow (PFOF), and the formulation of the national best bid and offer (NBBO). Gensler repeated his concerns about equity market structure in later remarks before the SEC's Investor Advisory Committee, in which he also reiterated his plans for Commission staff to reconsider the rules applicable to Exchange Act Rule 10b5-1 trading plans, the topic of his first substantive remarks as SEC chair, which he delivered a few days ago.

Competition issues. Gensler began his speech by focusing on the ways in which equity markets may be less competitive than they could be. According to Gensler, market segmentation results in different requirements for different types of firms; for example, market makers compete against each other on price, but wholesalers can set prices based on the less competitive NBBO. Gensler also cited data showing that only 53 percent of the market is lit, whereas the unlit market divides into alternative trading systems or dark pools (9 percent) and off-exchange wholesalers (38 percent). Gensler also said that off-exchange wholesale markets are dominated by seven firms.

Gensler further explained that market concentration plays a role in setting equity prices. According to Gensler, concentration can result in less competition, may hinder innovation, and has the potential to produce systemic risk in the event that a major firm fails. As an example of concentration, Gensler cited a webpage published by Citadel Securities boasting that the firm handled 47 percent of U.S.-listed retail volume, making the firm the "top wholesale market maker."

PFOF and gamification. Gensler next addressed several issues that reemerged in January 2021 when "meme" stock trading produced several days of severe market volatility. One part of the meme stock issue is payment for order flow (PFOF), which Gensler broke into two sub-issues focused on payments for routing orders and the rebates paid by exchanges to market makers. For Gensler, one of the key issues surrounding PFOF is the trove of transaction data available to a few firms that handle large volumes of equities trading. Gensler noted the Commission's settlement in December 2020 with Robinhood Financial, LLC regarding PFOF and best execution issues that resulted in Robinhood being censured and ordered to pay a civil money penalty of $65,000,000.

With respect to gamification, Gensler expressed concern about the use of behavioral prompts by firms to entice retail investors to trade more frequently. Gamification is often paired with low or zero-cost trading fees. Gensler said he had asked Commission staff to prepare a request for public comment on the issues of PFOF and gamification.

A recent blog post by Sheppard Mullin attorneys Sarah Aberg and Shane Killeen regarding the Financial Industry Regulatory Authority, Inc.'s annual conference suggested that the SEC is not the only regulator considering the impact of the gamification of stock trading. According to the blog post, FINRA officials hinted that it may seek public comment on broker-dealers' gamification practices.

NBBO. According to Gensler, best execution requires best execution, not just better execution. He also suggested that the current formulation of the NBBO may not capture as much of the market as it should. For one, Gensler, citing January 2021 data, said the NBBO would not apply to nearly half of he equity market because many types of firms are excluded from the NBBO. Market segmentation, Gensler added, also could affect the width of the bid-ask spread. Lastly, Gensler cited a number of additional factors that may undermine the NBBO, including the absence of odd lots, the absence of non-displayed orders, and the use of penny increments.

As a result, Gensler said he had asked Commission staff to make recommendations on a range of topics around market structure. The staff review will include:

- Best execution.
- Regulation NMS.
- PFOF (including reviews of PFOF in both the on- and off-exchange settings).
- Minimum pricing increments.
- Formulation of the NBBO.

Clearance and settlement. As an addendum to the speech, Gensler hinted at potential changes to the settlement process. He noted that technological advances have made it possible to further shorten the settlement cycle from the current T+2 to a range between T+1, T+0, or T+evening. Several years ago, the Commission re-set the settlement cycle from T+3 to T+2. Moreover, Gensler said that he had asked Commission staff to consider whether there are gaps in central clearing, an inquiry he said could focus on money movements, netting, and the posting of collateral.

Roisman, Peirce remarks. Commissioners Elad Roisman and Hester Peirce both offered remarks alongside Gensler at the SEC Investor Advisory Committee meeting. Although not directly addressing Gensler's speech from the day before, Roisman suggested a need for the Commission to provide "non-prescriptive guidance" on what constitutes best execution. Roisman also said the Commission could improve the monthly quality reports required under Exchange Act Rule 605 while also possibly expanding them to specifically address retail broker-dealers.

But Roisman said any changes to the rules governing equity market structure will need to account for many factors. "The Commission is at its best when it devotes its resources to *competition enhancing initiatives* that foster market integrity and lower costs for investors. We should not prescribe outcomes. And we should not pick winners and losers," said Roisman (emphasis in original).

Commissioner Peirce did mention Gensler's prior speech on equity market structure in remarks to the SEC's Investor advisory Committee. With respect to best execution, Peirce agreed that rebates present conflicts of interest similar to those that arise with PFOF. "I expect that today's discussion will remind us not only of the potential conflicts for brokers arising from these payments, but also of the benefits that they seem to bring, particularly in the form or lower (or zero) transaction costs for retail investors," said Peirce.

Attorneys: Sarah Aberg and Shane Killeen (SheppardMullin).

Companies: Robinhood Financial, LLC; Citadel Securities

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