Securities Regulation Daily Wrap Up, TOP STORY—SEC chair addresses Congress in GameStop III hearing, (May 6, 2021)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By John M. Jascob, J.D., LL.M.

SEC Chair Gary Gensler joined FINRA's Robert Cook and DTCC's Michael Bodson in testifying on the need for regulatory and market structure changes following the short squeeze in "meme stocks."

Making his first appearance before the House Financial Services Committee since his Senate confirmation in mid-April, SEC Chairman Gary Gensler faced several hours of scrutiny from lawmakers concerning the Commission's potential regulatory response to the January 2021 market volatility stemming from the short squeeze on GameStop, Inc. and other "meme" stocks.

In the third in a series of committee hearings concerning potential regulatory and legislative changes required by January's social media-driven trading frenzy, Gensler, FINRA CEO Robert Cook, and Depository Trust & Clearing Corporation CEO Michael Bodson addressed issues concerning payment for order flow, short sale disclosures, and the growing impact of social media and technology on the U.S. capital markets, among other topics.

Technology and policy. In his opening remarks, Gensler noted that the policy issues raised by this winter's volatility go beyond just the meme stocks. In his view, these events represent part of a larger story about the intersection of finance and technology, forces which have had a symbiotic relationship since antiquity. As he phrased the inquiry in his prepared remarks, Gensler said that central question facing regulators is this: "When new technologies come along and change the face of finance, how do we continue to achieve our core public policy goals and ensure that markets work for everyday investors?"

Gensler said that the Commission expects to publish in the summer a staff report assessing the market events in January. In addition, the SEC staff is reviewing these events for potential violations, and he has directed staff to consider whether expanded enforcement mechanisms are necessary. In the meantime, however, Gensler highlighted several key factors that were at play in the volatility.

For example, Gensler observed that mobile investing apps are employing a host of features that have come to be familiar in the broader online world, including gamification, behavioral prompts, predictive analytics, and differential marketing. While we might only lose a couple of hours of our evening if we watch a bad movie that a streaming app recommends, following the wrong prompt on a trading app could have a substantial effect on a saver's financial position, Gensler said. Accordingly, Gensler has asked the SEC staff to prepare a request for public comment on these issues in order to ensure investors using apps with these types of features continue to be appropriately protected and consider how all the SEC's rules apply in these situations, including Regulation Best Interest.

Turning to the topic of best execution, Gensler said that many retail broker-dealers have stopped charging fees for trades but instead make money through other streams, including payment for order flow. For example, pioneering no-fee brokerage Robinhood publicly reported $331 million in payment for order flow revenues in the first quarter of 2021, tripling the amount it brought in during the first quarter of 2020. While payment for order flow does provide some benefits, higher volumes of trades generate more payments for order flow, raising questions concerning whether broker-dealers have inherent conflicts of interest and whether customers are getting best execution in the context of that conflict. The high concentration of retail orders routed to a small number of wholesalers also raises questions about market structure, Gensler said, as market concentration can lead to

fragility and deter competition. Gensler said that he has asked the SEC staff to look closely at these issues to determine which policy approaches may be merited.

With regard to investors' use of social media to discuss securities, Gensler stressed that he was not concerned about regular investors exercising their free speech online. Rather, he is more concerned about bad actors potentially taking advantage of influential social media platforms. Gensler added that it is no longer just retail investors or even humans who are following online conversations, but institutional investors using computer programs. This practice, known as "sentiment analysis," presents the risk that bad actors may try to send signals to manipulate the market, and is an area for which the SEC will continue to deepen its understanding and capabilities.

Accelerated settlement. Michael C. Bodson, CEO of the Depository Trust & Clearing Corporation (DTCC), noted that National Securities Clearing Corporation (NSCC), the DTCC subsidiary that acts as the central counterparty that clears cash transactions in the U.S. equities markets, experienced the two highest transaction volume days in its history during the GameStop short squeeze in late January. On Wednesday, January 28, NSCC processed approximately 474 million transaction sides, exceeding the March 2020 volume record by more than 100 million. While extreme market volatility and even "short squeeze" events are not new phenomena, what was unusual, Bodson said, was that activity in the volatile meme securities was also more concentrated in the portfolios of firms that primarily support individual investors.

With regard to margin requirements, Bodson said that margin protects NSCC and all market participants against clearing member defaults, and that margin requirements must be met by clearing members on a timely basis. In his view, shortening the settlement cycle beyond T+2 would reduce the risks that drive margin requirements and further reduce costs to clearing members. Bodson said that the industry is increasingly prepared to move to T+1 settlement, and that DTCC's analysis suggests that T+1 settlement could reduce NSCC value-at-risk or "VaR" charges by as much as 40 percent, potentially saving clearing members more than $6 billion per day in margin requirements during periods of extreme volatility.

FINRA's response. FINRA CEO Robert Cook observed that innovations in technology and methods of communication can be beneficial for investors, but they can also present new and sometimes unanticipated risks. The ongoing evolution in the markets and related changes in investor behavior require regulators to continually review the rules governing securities markets more generally and consider whether they should be updated to better protect investors and promote market integrity. Cook said that many of the issues surrounding the January market volatility involve questions of SEC policy. Accordingly, FINRA looks forward to reviewing the SEC's findings and to working collaboratively with the Commission to develop and implement any appropriate responses to those events based on those findings.

In addition, however, FINRA has an internal working group devoting significant resources to reviewing member firm conduct during the recent market events to assess compliance with SEC and FINRA investor protection and market integrity rules. For example, FINRA has been reviewing the order routing practices of member firms, including practices where payment for order flow is involved, to assess compliance with order handling and best execution requirements. FINRA has also been examining firms for compliance with short sale requirements and has been reviewing the circumstances under which member firms imposed trading restrictions on customers, including whether retail customers received fair treatment consistent with applicable rules during the periods of extreme market volatility, Cook said.

MainStory: TopStory BrokerDealers ClearanceSettlement Enforcement ExchangesMarketRegulation FraudManipulation GCNNews RiskManagement