Securities Regulation Daily Wrap Up, BROKER-DEALERS—Commissioner Peirce urges regulators and investors to embrace technology, (Feb. 23, 2021)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Mark S. Nelson, J.D.

Peirce would take a cautious approach to further regulation of payment for order flow in wake of the GameStop-related market volatility.

SEC Commissioner Hester Peirce recently gave a speech in which she touted the benefits of technology and urged listeners to not be afraid of technology while acknowledging that some fintech ideas are not yet feasible, either because of regulatory hurdles or the lack of adequate disclosure. Peirce, who delivered her remarks at the George Washington University Law School Regulating the Digital Economy Conference, said she was motivated in choosing her topic by the market turmoil that arose from the GameStop short squeeze and the attendant legislative fallout, all of which had reminded her of the bubble in uranium markets described in a book she had read.

Fear of technology? According to Peirce, investors and regulators will need to change their "attitude" if regulators and markets are going to accept technological changes that make trading faster or the dissemination of some types of information easier. "Specifically, we tend to look at technological innovation in the markets with deep suspicion, and that mindset has to change," said Peirce. "Attempts to create a good experience using an attractive, easy-to-navigate interface run headlong into a dusty set of regulations written with paper, snail mail, and precise legalese in mind."

But Peirce suggested that some technological changes may have to occur over time. For example, Peirce noted the gradual regulatory shortening of the settlement cycle from three days to two (i.e., T+3 to T+2), despite the calls of some to further shorten the cycle to T+0 or to allow settlement in real time. Peirce said that the current settlement cycle builds in some amount of delay between execution and settlement and that it is this delay that allows the settlement system to function (i.e., delay allows for error correction and human intervention).

"Real-time settlement would address many of the concerns around central clearing and margin calls that we saw late last month," said Peirce. "Widespread adoption of real-time, or at least near real-time, settlement of transactions in equity securities, however, would require a major overhaul in the way equity markets work and could harm liquidity by raising the cost of making markets."

Peirce, however, suggested that a more incremental approach to the settlement cycle might be best, especially an approach focused on modernizing the post-trade settlement process. She said this type of incremental change could still yield "significant" benefits.

The concluding paragraphs of Peirce's remarks take on the topic of payment for order flow (PFOF) that has generated much discussion after the volatility in GameStop's stock and the later congressional hearing on GameStop. For Peirce, however, the lesson of GameStop is not to ban PFOF but to mandate better disclosures to investors, whom she suggested are likely to benefit from price improvement associated with PFOF. Said Peirce: "At the same time, critics are correct when they point out the potential for conflicts of interest on the part of the broker, who may be tempted to send trades to a market-maker who offers worse execution pricing (which hurts the investor) but better payment for order flow (which benefits the broker). The way to address this potential conflict, though, is not to ban the practice—which would eliminate a potential conflict at the cost of a likely increase in costs to the investor—but to require better disclosure."

Q&A session. GW later posted a video Q&A session with Peirce. Morenike Saula, Visiting Associate Professor of Law and Business, Finance, and Entrepreneurship Law Fellow at The George Washington University Law School, moderated the first half of the Q&A session following Peirce's remarks. Saula noted that Nigeria had recently banned trading of virtual currencies and asked Peirce about, among other things, how technology can lead to financial inclusion. Peirce explained that decentralized finance or DeFi can paly a role by removing the human part of interaction through the use of smart contracts. The discussion of smart contract did not directly address the issues that can arise from the fact that humans write the code that runs those same smart contracts.

The second half of the Q&A was moderated by Abraham Bluestone, Class of 2021, and Chair of the Finance Law Conference Committee. The first question came from panelist Carol Van Cleef, Counsel at Bradley, who asked about media reports that regulators were looking into stablecoins. Peirce noted the general market interest in stablecoins arising from Diem (formerly known as Facebook-backed Libra) but she said stablecoins mostly are beyond the SEC's jurisdiction unless they have features that look like securities. Peirce urged stablecoin developers to talk to SEC staff.

With respect to exchange traded products involving virtual currencies, Peirce replied to a questioner that the number one question is when the SEC might approve an ETP. Peirce noted her prior dissents from SEC disapprovals of virtual currency ETPs and she added that the SEC has in these applications looked more closely at the underlying workings of the Bitcoin market. Peirce said she was hopeful that Gary Gensler, who has been nominated to become SEC chair, and who has experience with virtual currencies, could mean that the agency will take a fresh look at its approach to regulating virtual currencies.

In reply to a question about GameStop, Peirce noted that short selling has a valuable role in the economy, such as providing rewards to those who investigate companies and learn more information about them, including revealing potential fraud. She also said short selling can help to create liquidity. Moreover, without citing a specific research report, Peirce said there was some research that suggests the presence in the market of short sellers can actually cause stock prices to rise over time. But Peirce said there must be a balance between short selling and any further transparency requirements. She also reminded listeners that there are rules for naked short selling that require short sellers to actually borrow the needed shares.

Another questioner wanted to know about regulation of special purpose acquisition companies or SPACs. Peirce acknowledged that SPACs were back in fashion and that SPACs provide a pathway for private companies to go public, although she said the growth of SPACs may raise questions too, such as whether traditional IPOs are too expensive or are otherwise just not working. Peirce added that it is a "positive" that companies have options for going public, but it is important to make sure there is good disclosure associated with those options.

RegulatoryActivity: Blockchain BrokerDealers CorporateFinance CorporateGovernance ExchangesMarketRegulation FedTracker Securities FinancialIntermediaries GCNNews HedgeFundsNews InvestorEducation IPOs PrivateEquityNews PublicCompanyReportingDisclosure RiskManagement SECNewsSpeeches SecuritiesOfferings ShareholderActivismNews