February 17, 2021

Hon. Maxine Waters
Chairwoman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Hon. Patrick McHenry
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Hon. Brad Sherman
Chairman
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
Committee on Financial Services,
U.S. House of Representatives
Washington, D.C. 20515

Hon. Bill Huizenga
Ranking Member
Subcommittee on Investor Protection,
Entrepreneurship, and Capital Markets
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Re: Hearing on Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide

Dear Chairwoman Waters, Ranking Member McHenry, Chairman Sherman, Ranking Member Huizenga, and Members of the Committee:

Thank you for your ongoing efforts to promote robust capital markets. The Healthy Markets Association[1] appreciates the opportunity to submit our thoughts on the issues arising out of the recent unusual trading and subsequent market events regarding GameStop stock and several other so-called “meme” stocks.[2]

Market participants, regulators, and lawmakers should be concerned. The capital markets exist to fund companies, create jobs, and drive our economy, while also helping millions of American families save for retirement, college, or to buy homes. Unfortunately, the secondary market trading of securities seems to be increasingly disconnected from these essential tasks.[3] Investors, companies, executives, creditors,

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[1] The Healthy Markets Association is an investor-focused not-for-profit coalition working to educate market participants and promote data-driven reforms to market structure challenges. Our members, who range from a few billion to hundreds of billions of dollars in assets under management, have come together behind one basic principle: Informed investors and policymakers are essential for healthy capital markets. To learn more about Healthy Markets, please see our website at http://www.healthymarkets.org.

[2] For a good discussion of “meme” stocks, we encourage you to read My Wall Street blog. *What is a “Meme Stock”?,* My Wall Street, Feb. 2. 2021, *available at* https://blog.mywallst.com/what-is-a-meme-stock/.

[3] We note that this phenomenon is not confined to just “meme” stocks. Rather, this phenomenon has been a feature of the private markets for quite some time and is also prevalent in the difficult-to-justify explosion of Special Purpose Acquisition Companies (SPACs), and valuations of so-called “cryptocurrencies”, such as Bitcoin. In each set of assets, the prices of the securities seem to have little relationship to the underlying assets, liabilities, and other fundamental factors of the instrument.

workers, and others have become justifiably concerned with the integrity, stability, and long-term prospects of our markets, as asset prices have been artificially manipulated "to the moon"[4] and back.

Unless promptly addressed by Congress and regulators, these concerns may ultimately lead to a deterioration of the public markets, a loss of investor confidence in the integrity and stability of the markets, and less overall investment.

At the same time, we must recognize that while these developments are troubling for most of us, they are good business for some market participants. It is not lost on us, for example, that just as GameStop and other "meme" stocks began their violent price fluctuations, Robinhood set records with both the number of daily downloads and daily users.[5]

We urge you to focus on what's best for the markets overall, and not just what may be best for a handful of politically well-connected financial institutions. We urge you to explore not only what happened, but also the broader trends in our capital markets that are highlighted by these events, the risks for investors, issuers, and the markets overall, and what should be done to strengthen our capital markets.

Below, we review some of the issues raised by recent events and offer suggestions for regulators and lawmakers.

Market Manipulation

Preventing market manipulation was a key driver behind the creation of the federal securities laws.[6] Interestingly, the securities laws themselves do not define "manipulation," and the SEC has also never clearly defined the term.[7]

Nevertheless, the SEC has long promoted the integrity of prices in its markets through bringing enforcement actions to prevent market manipulations. For example, the SEC has brought actions against stock promoters and firms engaged in trading strategies intended to mislead the public into thinking there is more interest in a security than

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[4] See, Ian Sherr, *GameStop stock crashed, but Reddit still wants to send it to the moon. How and what's next*, Cnet, Feb. 4, 2021, *available at* https://www.cnet.com/personal-finance/gamestop-stock-crashed-but-reddit-still-wants-to-send-it-to-the-moon-how-and-whats-next/.

[5] Adam Blacker, *Reddit's wallstreetbets thread generates strong interest in retail investing*, Apptopia, Jan. 28, 2021, *available at* https://blog.apptopia.com/reddits-wallstreetbets-thread-generates-strong-interest-in-retail-investing.

[6] William A. Roach, Jr., *Hedge Fund Regulation: "What Side of the Hedges Are You on?"*, 40 U. Mem. L. Rev. 165, 178 (2009) ("The shocking results of the [congressional] investigation uncovered high levels of market manipulation and led Congress to pass the first federal securities laws, the Securities Act of 1933.").

[7] Merritt B. Fox, Lawrence R. Glosten, and Gabriel V. Rauterberg, *Stock Market Manipulation and Its Regulation*, Yale J. Reg. 35, no. 1 (2018): 67-126, *available at* https://repository.law.umich.edu/cgi/viewcontent.cgi?article=2978&context=articles.

really exists (a practice often called "painting the tape").[8] The SEC has warned investors about the risks of pump and dump schemes using social media,[9] and brought cases against individuals and firms for engaging in "pump and dump" schemes.[10] It has also brought cases for violating its short selling rules.[11]

The Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers, has both relevant rules and a long record of enforcement. In particular, FINRA Rule 2020 says "No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance."[12] This broad rule has been used to cover a wide range of broker-dealer misconduct.

Further, both the SEC and FINRA have rules designed to ensure that broker-dealers have effective systems and controls in place to prevent manipulative behavior by those to whom they may grant access to the markets.[13]

Lastly, registered securities exchanges (like New York Stock Exchange LLC), are also obligated to have and enforce rules designed to prevent manipulative trading on their venues. Exchanges have exercised this authority to stop trading in their listed stocks, and Nasdaq's CEO has recently declared that it would exercise authority to halt trading in a stock if the exchange ties "unusual" trading with "social media chatter."[14]

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[8] *See, e.g.*, *SEC v. Joseph A. Fiore, Berkshire Hathaway Capital Mgmt Co., Inc., et. al*, 18-CV-5474, (S.D.N.Y. 2018), *available at* https://www.sec.gov/litigation/complaints/2020/comp24795.pdf.

[9] *See, e.g., Updated Investor Alert: Social Media and Investing -- Stock Rumors*, Investors Alerts and Bulletins, SEC, Nov. 5, 2015, *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ia_rumors.html.

[10] *See, e.g.*, Press Release, *SEC Charges Three Penny Stock Promoters Behind Pump-and-Dump Schemes*, SEC, July 21, 2015, *available at* https://www.sec.gov/news/pressrelease/2015-152.html (using multiple websites to promote stocks); *see also SEC v. Carol McKeown, et. al.*, 10-80748-CIV-COHN (S.D. Fla. June 23, 2010) (asset freeze for promoters of penny stocks who used social media to spread claims).

[11] *See, e.g.*,Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of SEC v. Gonul Colak and Milen K. Kostov*, SEC, Admin. Proc. File No. 3-15712, Jan. 31, 2014, *available at* https://www.sec.gov/litigation/admin/2014/33-9522.pdf.

[12] *FINRA Rule 2020, Use of Manipulative, Deceptive or Other Fraudulent Devices*, FINRA *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/2020#the-rule.

[13] See 17 CFR § 240.15c3-5 (for SEC). These access rules and controls are considered essential market protections, and are regularly enforced. *See, e.g.*, *Letter of Acceptance, Waiver, and Consent for Jefferies Executions Services, Inc.*, FINRA, AWC No. 2014043557401, Dec. 12, 2019, *available at* https://www.finra.org/sites/default/files/fda_documents/2014043557401%20Jefferies%20Execution%20Services%2C%20Inc.%20nka%20Jefferies%20LLC%20CRD%20867%20AWC%20%282020-1578874778719%29.pdf (action for failure to have adequate systems to identify and stop manipulative trading by customers who were using the brokers' systems).

[14] Emily Graffeo, *Nasdaq CEO Friedman says the exchange will halt trading in a stock if they link unusual activity to social media chatter*, Business Insider, Jan. 27, 2021, *available at* https://markets.businessinsider.com/news/stocks/nasdaq-monitors-social-media-halts-unusual-trading-friedman-market-manipulation-2021-1-1030011156.

Obviously, the SEC should be working with FINRA and the exchanges to investigate instances of potential manipulation, and we are assuming they are doing exactly that. But there are significant questions of fact and rules that must still be explored.

If investment advisers, broker-dealers, or other registered persons (or corporate insiders) were engaging in communications that could be reasonably expected to or were intended to influence the prices of stocks, did those persons fully and accurately disclose their positions in such securities or related securities? Have they disclosed all payments made to, or received from, third parties, that are related to their public communications? Have they used "bots" to make or promote statements on social media, or used algorithms to monitor and shape social media sentiment? Are they coordinating trading among accounts to increase the volume of trading? Are they aware of any customer or other persons doing any of the foregoing?[15]

We wonder why trading in several of the "meme" stocks was not halted, once it was clear that the trading was by any lay definition, manipulative. If the SEC, FINRA, or exchanges' rules do not cover such instances, should they be modernized to clearly ensure that trading prices are legitimate, and not manipulated?[16]

At the same time, we understand why investors, commenters, and market participants may be confused by the rules and enforcement regarding manipulation. For years, we have all seen claims on television, in print media, and more recently, on social media platforms, that appear designed to "promote" a wide range of assets, including specific stocks. Increasingly, these promotional activities by registered persons, corporate insiders, and others cover assets that may be outside of the SEC's primary jurisdiction, such as Bitcoin. In some cases, the communications posted on various media platforms were of a nature that, if instead of being public consisted of private emails between two parties, would likely be exhibited in manipulation cases by regulators or even federal prosecutors.

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[15] *See, e.g., Fraud Prevention: FINRA Urges Firms to Review Their Policies and Procedures Relating to Red Flags of Potential Securities Fraud Involving Low-Priced Securities*, FINRA, Regulatory Notice 21-03, Feb. 10, 2021, *available at* https://www.finra.org/sites/default/files/2021-02/Regulatory-Notice-21-03.pdf (outlining responsibilities of brokers to combat fraud and offering warning signs for brokers to help detect it).

[16] Other market regulators, such as those overseeing energy markets, have been proactive in defining indicia of, and combatting, market manipulation. Joseph Zabel, *Rethinking Open- and Cross-Market Manipulation Enforcement*, __ Va. L. & Bus. Rev. __ (forthcoming) *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3682103. Additional statutory authority does not explain the relative success of energy regulators compared to their federal securities counterpart; anti-manipulation provisions of federal energy statutes are explicitly based on Section 10 of the Securities Exchange Act of 1934. *Id.* We note that other countries have clear efforts to stop large price swings in small cap stocks. *See, e.g.*, Ronojoy Mazumdar, *Why GameStop Frenzies Likely Won't Be Coming to India*, Bloomberg, Feb. 9, 2021, *available at* https://www.bloomberg.com/news/articles/2021-02-10/stock-market-warning-system-from-india-curbs-gamestop-like-gains?utm_medium=social&cmpid=socialflow-twitter-business&utm_content=business&utm_source=twitter&utm_campaign=socialflow-organic (explaining how a 2017 rule of the Securities and Exchange Board of India may stop manipulative trading in small caps).

If the SEC, FINRA, and exchanges cannot police people and firms engaging in campaigns and trading strategies that are intended to artificially move securities prices without any regard to the actual value of the securities, then their rules are inadequate.

Best Execution and Conflicted Order Routing Incentives

Conflicted order routing practices exploit investors and provide incentives that exacerbate risks for the markets. Ending conflicted order routing practices and enforcing best execution should be a significant focus for regulators and lawmakers.

Investors should never have to wonder whether their broker is routing their order in a way that puts the broker's profit interests ahead of theirs. That's because brokers acting as agents have a duty of "best execution,"[17] which is "a key investor protection requirement."[18] The duty of best execution is based on the "duty of loyalty," and "any broker-dealer, when acting as agent on behalf of a customer in a transaction, is under a duty to exercise reasonable care to obtain the most advantageous terms for the customer."[19] While many factors may be considered for best execution, the principal factor is nearly always best prices. This is particularly true for smaller trades for which the trade may have little or no price impact.

Best execution requires brokers to engage in "reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible,"[20] including actively and regularly considering alternative market centers, including those to which it may not route orders. [21] Further, "a broker-dealer must not let a payment or an inducement for order flow to interfere with its efforts to obtain best execution."[22]

Unfortunately, regulators in the United States have nevertheless long permitted brokers (even when acting as agents) to accept incentives for order routing, which they can keep and not disclose to their customers.[23] Thus, US regulators have essentially taken the untenable position that brokers may receive payments, which now total hundreds of millions of dollars for individual firms, and yet pretend that these payments will have no

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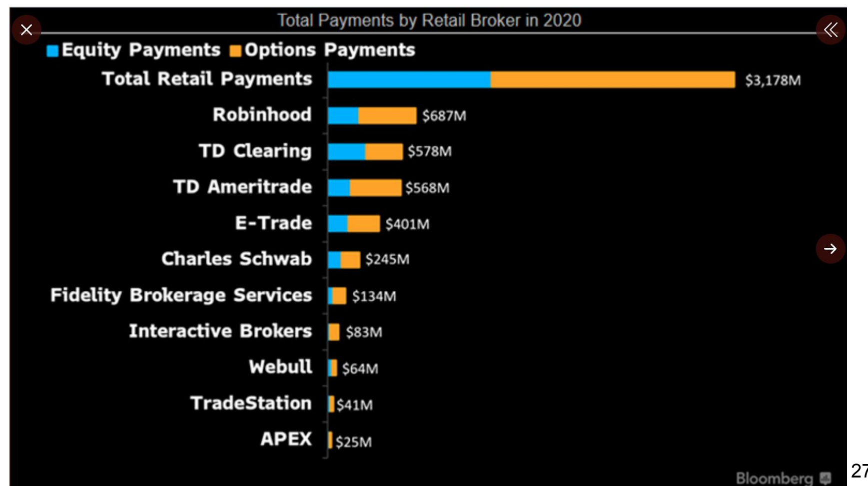
[17] *Rule 5310: Best Execution and Interpositioning*, FINRA, *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310.
[18] *Best Execution Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, FINRA, Notice to Members 15-46, Nov. 2015, *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf (FINRA 15-46).
[19] FINRA 15-46, at 2.
[20] FINRA Rule 5310, FINRA, *available at* https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310.
[21] Id.
[22] *Payment for Order Flow, Confirmation of Transactions*, SEC, 59 Fed. Reg. 55006, 55009 (Oct. 27, 1994).
[23] Recently, the SEC required retail brokers to disclose their receipt of payments for order flow, but those numbers are aggregated for all customers and are generally hard to find and incomprehensible for most "retail" customers.

impact on those brokers' decisions. Not surprisingly, regulators in other countries have disagreed. Payment for order flow has been banned in the United Kingdom since 2012, [24] and is also prohibited in other developed countries, including Australia, Canada, and India.[25]

Even in the United States, some retail brokers (explicitly citing the conflict of interests the payments create) will not accept payment for order flow,[26] while other agency brokers accept very large payments. Robinhood, a relative newcomer to the industry, seems to be receiving some the largest payments.



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[24] See, CFA Institute, *Payment for Order Flow in the United Kingdom*, June 2016, available at https://www.cfainstitute.org/-/media/documents/article/position-paper/payment-for-order-flow-united-kingdom.ashx (finding that the Financial Stability Authority's clarification that existing best execution obligations prohibited PFOF, more "retail" sized trades were executing at the best prices available on exchanges, despite a lack of a "trade through" rule and decrease in reported "price improvement.").

[25] *Report on Order Routing Incentives*, The Board of the International Organization of Securities Commissions (IOSCO), CR07-2016, Dec. 2016, *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD551.pdf.

[26] *See, e.g.*, Declan Harty, *Schwab CEO: Fidelity's payment for order flow claims not 'the whole story'*, Oct. 22, 2019, *available at* https://www.spglobal.com/marketintelligence/en/news-insights/trending/IiJL9zOpAk76f_BrDunluA2 ("Fidelity puts the interests of its customers first. Schwab is trying to distract from the issue and confuse investors," a Fidelity spokesperson said in an email. "Schwab gets paid at the expense of their customers on equity orders — Fidelity does not. Schwab has an opportunity to give their customers a better price and they do not."). Additionally, we understand that Vanguard does not accept payment for order flow for equities trades, but does for retail options trades. *Vanguard Brokerage Services Annual Notice*, Vanguard, Apr. 2020, *available at* https://personal.vanguard.com/pdf/v719.pdf.

[27] See Twitter, @ltabb, Feb. 12, 2021, *available at* https://twitter.com/ltabb/status/1360223701074128898.

Some have speculated[28] based on Robinhood's public reports[29] that it is accepting payments for order flow in percentage of spread terms, although this has not been established.

We encourage this Committee and regulators to seek copies of all order routing arrangements between Robinhood and its market makers, and would similarly encourage the Committee to explore whether and how Robinhood factors receipt of payment for order flow into its order routing decisions for different types of orders and asset classes.

We also note that, in December 2019, Robinhood settled an action with FINRA for failing to have and follow appropriate processes even to attempt to achieve best execution.[30] In January 2021, Robinhood settled a separate action with the SEC for $65 million for failing to obtain best execution for its customers, failing to have and follow appropriate processes with which to do so, and for inadequately informing customers about its receipt of payments for order flow.[31]

Similarly, in 2017, Citadel settled an action brought by the SEC over its retail market making practices.[32] According to the settlement, Citadel

> provided a written disclosure to certain of its retail broker-dealer clients that described a market order as an "[o]rder to buy (sell) at the best offer (bid) currently available in the marketplace," and made other, similar representations to its clients.
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> These statements were materially misleading [because they] suggested that [Citadel] would either internalize a marketable order at, or seek to obtain for that order through routing, the best price for that order that [Citadel] observed

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[28] See, e.g., Twitter, @eleven_seconds, Feb. 4, 2021, *available at* https://twitter.com/eleven_seconds/status/1357211039868227592?s=20.

[29] See, Robinhood Securities LLC - Held NMS Stocks and Options Order Routing Public Report, Robinhood, Jan. 25, 2021, *available at* https://cdn.robinhood.com/assets/robinhood/legal/RHS%20SEC%20Rule%20606a%20and%20607%20Disclosure%20Report%20Q4%202020.pdf. Interestingly, while these reports are ostensibly provided pursuant to Rule 606 of Regulation NMS, it is not entirely clear if the reports fully comply with the reporting obligations.

[30] *See, e.g.*, *Letter of Acceptance, Waiver, and Consent for Robinhood Financial, LLC.*, FINRA, AWC No. 2017056224001, Dec. 19, 2019, *available at* https://www.finra.org/sites/default/files/2019-12/robinhood-awc-121919.pdf.

[31] *In the Matter of Robinhood Financial, LLC*, Admin. Proc. No. 3-20171, Dec. 17, 2020, *available at* https://www.sec.gov/litigation/admin/2020/33-10906.pdf.

[32] *In the Matter of Citadel Securities LLC*, Admin Proc. 3-17772, Jan. 13, 2017, *available at* https://www.sec.gov/litigation/admin/2017/33-10280.pdf.

> on the various market data feeds it referenced, which FastFill and SmartProvide did not do.[33]

Essentially, Citadel was falsely claiming that it was providing its retail broker dealer customers with the “best” available prices in the markets, when it was instead providing them with inferior prices. Oddly, however, the enforcement case seemed to rest on Citadel’s false claims that it was providing the ‘best” prices, rather than the substantive failure to provide best execution.

This raises the question of whether regulators are sufficiently applying and enforcing the duty of best execution upon the market makers to whom retail brokers route orders. If the duty of best execution cannot be readily applied to those firms, then it must be revised.

Further, and perhaps most importantly, we urge Congress and regulators to explore whether market makers are currently providing retail customers with executions at prices that are inferior to the best prices available at any time between receipt of the order and its execution, as seen by whatever data sources are used by the market maker.[34] As explained in greater detail below, there is significant evidence that a large number of retail orders, for example, are receiving inferior prices to what may be available on exchanges.

Importantly, conflicted order routing by brokers is not just a problem for so-called “retail” customers. The same conflicts of interest occur in "institutional" trading as well. For years, pension funds and investment advisers implored Congress and the SEC to adopt a study of their brokers’ order routing practices that would, at heart, prohibit exchanges from paying order routing incentives. The SEC’s Equity Market Structure Advisory Committee recommended an “Access Fee Pilot” to study these incentives in 2016.[35] In response to massive outcry from pension funds and mutual funds, the SEC adopted a "transaction fee pilot" in 2018 that would have eliminated those payments for up to two years to "study" the impact.[36] The DC Circuit vacated the SEC’s rule adopting the transaction fee pilot last year.[37]

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[33] Id.

[34] See, *Best Execution Guidance on Best Execution Obligations in Equity, Options and Fixed Income Markets*, FINRA, Notice to Members 15-46, Nov. 2015, at 13 n.12, *available at* https://www.finra.org/sites/default/files/notice_doc_file_ref/Notice_Regulatory_15-46.pdf (FINRA 15-46) (stating that “a firm that regularly accesses proprietary data feeds, in addition to the consolidated SIP feed, for its proprietary trading, would be expected to also be using these data feeds to determine the best market under prevailing market conditions when handling customer orders to meet its best execution obligations.”).

[35] Recommendation for an Access Fee Pilot, Equity Market Structure Advisory Committee, SEC, July 8, 2016, *available at* https://www.sec.gov/spotlight/emsac/recommendation-access-fee-pilot.pdf.

[36] Press Release, *SEC Adopts Transaction Fee Pilot for NMS Stocks*, SEC, Dec. 19, 2018, *available at* https://www.sec.gov/news/press-release/2018-298.

[37] *New York Stock Exchange, LLC v. SEC*, 2020 WL 3248902 (D.C. Cir. June 16, 2020), *available at* https://www.cadc.uscourts.gov/internet/opinions.nsf/BE5AD5AD3C0064408525858900537163/$file/19-1042-1847356.pdf.

Congress, in the past, has explored brokers' conflicted order routing practices in detail. For example, in 2014, the US Senate Permanent Subcommittee on Investigation held a hearing on Conflicts of Interest, Investors Loss of Confidence, and High Speed Trading in U.S. Stock Markets.[38] At that hearing, an executive of one large, retail broker-dealer admitted that his firm routed "virtually" all of its orders to those who paid it the most.[39]

Unfortunately, after nearly a decade in which investors have urged the SEC to stop or at least study brokers' conflicted order routing practices, the practices have continued largely unabated.

On the "retail" side of things, these payments for order flow are some of the most significant ways for retail brokers to make money. As Robinhood's CEO, Vlad Tenev (a veteran high frequency trader) explained in 2014, "Robinhood has many revenue streams on Day One. Those include margin lending, payment for order flow, interest on cash balances. We'll have those on Day One."[40]

Offering leverage (and risk) to its retail customer base and exploiting conflicted order routing practices have been at the heart of its revenue model since its start. These revenue sources are, of course, less transparent and explicit for customers than traditional commissions, which Robinhood elected to forgo.

Using this "zero commission" model, Robinhood has grown rapidly. In fact, in part pressured by Robinhood's rapid expansion, many other retail broker dealers have stopped charging commissions. In effect, because of US regulators' inaction to prohibit payment for order flow or effectively enforce best execution, the entire retail brokerage industry has been reshaped. As the common expression now goes, "If you aren't paying for the product, you are the product."

While brokers' revenues formerly came mostly from the customers to whom they owe duties of loyalty, many brokers' revenues are increasingly dependent upon firms that are engaged in a zero-sum game against those brokers' own customers.

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[38] *Hearing on Conflicts of Interest, Investors Loss of Confidence, and High Speed Trading in U.S. Stock Markets*, before the the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, 113th Cong. (2014), *available at* https://www.govinfo.gov/content/pkg/CHRG-113shrg89752/html/CHRG-113shrg89752.htm.

[39] *Id.*, ("Senator Levin. And so, again, your subjective judgment as to which market provided best execution for tens of millions of customer orders virtually always led you to route orders to the markets that paid you the most. Mr. Quirk. No, it would not have always led us---- Senator Levin. I said 'virtually always.' Mr. Quirk. Virtually, yes.").

[40] Bruno J. Navarro, *Robinhood, a new app, offers free stock trades*, CNBC, Feb. 27, 2014, *available at* https://www.cnbc.com/2014/02/27/robinhood-a-new-app-offers-free-stock-trades.html.

Forgoing explicit commission revenue hasn't proven to be terribly troubling for many brokers, however, as retail brokers have experienced record revenues.[41] Clearly, they are making the revenues up somewhere else.

FINRA has raised significant concerns that the zero commission business model, coupled with inducements, has increased the brokers' incentives to route to markets and market makers that pay more, leading to worse prices for customers. FINRA has engaged in targeted examinations of the issues raised[42] and offered reports and guidance.[43]

The SEC, however, has done essentially nothing, other than requiring retail brokers to disclose the aggregated amount of the payments they receive for their customers' orders, which generally cannot be compared on a relative basis.

Conflicted Payments Undermine Integrity and Stability

Some have asserted that brokers' conflicted order routing practices and payment for order flow are unrelated to the recent events. They are wrong. Below, we explore how conflicted order routing practices, and payment for order flow in particular, contributed to and exacerbated recent events.

First, payment for order flow has, for many retail brokers, led to the elimination of explicit, disclosed transactions costs. An individual likely wouldn't send an order for a single share of a $10 stock into the market if she also had to pay a $9.99 explicit, per trade commission. This is likely to be a significant driver into the relative boom of retail trading at very, very low dollar amounts, including record amounts of "odd-lots."[44]

Second, with lower dollar amounts (and increased trading in fractional shares), people are seemingly taking greater trading risks. Psychologically, individuals are often more willing to take greater risks (i.e., gamble) with smaller dollars. There is also evidence that individuals are more likely to take greater risks while trading using their smartphones, as opposed to traditional computers.[45]

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[41] Maggie Fitzgerald and Kate Rooney, *E-brokers defy odds by recording record trading revenue while dropping commissions to zero*, CNBC, Aug. 20, 2020, *available at* https://www.cnbc.com/2020/08/20/e-brokers-defy-odds-by-recording-record-trading-revenue-while-dropping-commissions-to-zero.html.

[42] *Targeted Examination Letter on Zero Commissions*, FINRA, Feb. 2020, *available at* https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/zero-commissions.

[43] *Regulatory Obligations and Related Considerations*, FINRA, *available at* https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/best-execution.

[44] The terms "round lot" generally means 100 shares, and the term "odd lot" generally is used to denote a number of shares less than that. *See, e.g.*, Nasdaq Rule 4703(b).

[45] Steve Goldstein, *Why are markets going crazy? Smartphones, one study suggests*, MarketWatch, Jan. 25, 2021, *available at* https://www.marketwatch.com/story/heres-another-explanation-for-the-surge-in-speculative-activity-smartphones-11611579511.

Third, payments for order flow are often much greater for options orders. This is because spreads tend to be wider and best execution in options trading is far more difficult -- if not impossible -- to enforce for smaller volume options trades. Because market makers often make more money trading options, they are often willing to pay more for retail options orders. This incentivizes retail brokers who take payment for order flow in options to push their customers into options trading. Options may involve much greater levels of leverage and risk for retail customers.

Fourth, options trades (which are at all-time highs) often have outsized impacts on price movements for the underlying stock; essentially, the tail is wagging the dog. We have seen a significant rise in retail options trading over the past year, and the past few months in particular.

As Rich Repetto of Piper Sandler recently explained to CNBC:

> What accounts for these rises? Repetto believes the majority of the gains are due to increased retail participation, for several reasons:
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> 1. Record volume on the Trade Reporting Facility. The TRF is the "tape" that reports trades not done on the exchanges. It includes retail trades that are routed to market makers, as well as dark pools. The vast majority of retail trades (90%) are reported to the facility. TRF volume this month reached a record 48.6% of all trading. Repetto believes most of this is due to an increase in retail trading.
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> 2. Trades at retail brokers are way up. The average daily volume of the largest e-brokers in December was 6.6 million shares, a record. In January, average daily trades are at 8.1 million, a 23% increase.
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> 3. Options trading is way up. December saw an average of 32.7 million contracts trade on all the equity option exchanges, also a record. In January, 39.8 million contracts a day are trading. Repetto also cites data from Cboe indicating trading in single contract options have doubled in market share (4% to 8%) and tripled in volume in contracts per day.
>
> "You don't see an institution buying one contract," Repetto said. [46]

Fifth, while market makers may buffer some volatility at times, they may also exacerbate it. For example, when prices move in one direction for a while, market makers may end up trading in the same direction as those whose orders they are executing, and thus

[46] Bob Pisani, *Trading volume is up from 2020's breakneck pace as retail investors jump in*, CNBC, Jan. 22, 2021, *available at* https://www.cnbc.com/2021/01/22/trading-volume-is-up-so-far-from-2020s-breakneck-pace-as-retail-investors-get-even-more-active.html.

adding more buying or selling pressure. This is essentially what happened during the Flash Crash of 2010,[47] and there are reports that it may have happened in the recent trading of some of the "meme" stocks. Time and again, we have seen that market makers are unlikely to risk sacrificing their firms when faced with extreme market price swings.[48]

Sixth, as a result of its arrangements for order flow, at least one broker-dealer has determined to route its customers' orders exclusively to third-party market makers, and is not even a member of a registered exchange. But what happens if its market makers elect to stop taking its customers' orders (for whatever reason)? A retail broker-dealer that is entirely dependent upon market makers for executing its customers' orders, and is not a member of an exchange, may be unable to route its customers' orders into the marketplace. In times of market stress, this may exacerbate concerns with market integrity, stability, and overall health.

Add these factors together, and the payment for order flow regime is encouraging a large number of small dollar trades that are highly leveraged, and creating a system that may exacerbate price movements and fears regarding market integrity.

But there are other reasons for concern with the current retail trading practice of payment for order flow and the segmentation of customer orders. As retail orders have become an increasingly significant part of the market, it is increasingly difficult for institutional investors (i.e., pension funds and mutual funds) to trade. Retail orders generally don't end up being available for most institutional investors. As a result, many institutional investors are finding that their trading costs are rising significantly in stocks that have high degrees of retail trading.[49]

A solution that would address these concerns would be to prohibit brokers acting as agents from accepting payment for order flow.[50] This basic conflict of interest is the heart of many of the most troubling aspects of the modern US equity market structure. Importantly, by focusing exclusively on receipt of the payment by brokers acting as agents for customers, this could alleviate some concerns about banning payments to proprietary traders (where the agency-principal conflict doesn't exist). The restriction

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[47] *Findings Regarding the Market Events of May 6, 2010: Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues*, CFTC and SEC, at 3, Sept. 30, 2010, *available at* https://www.sec.gov/news/studies/2010/marketevents-report.pdf (noting that high frequency traders initially helped absorb the large selling pressure, but then flipped, and aggressively started to sell into it in an effort to reduce their positions).

[48] *See, e.g.*, Mark Carlson, *A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response*, Federal Reserve Board of Governors, 2007-13, at 5 n. 6, *available at* https://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf.

[49] Babelfish Analytics, *Meme Stocks: Inaccessible Trading Share, Trading Cost, and Risk*, Feb. 5, 2021, *available at* https://www.babelfishanalytics.com/news/2021/2/4/meme-stocks-inaccessible-trading-share-trading-cost-and-risk.

[50] Carl Levin, *Time to stop trading conflicts that cost investors billions*, Financial Times, Jan. 11, 2021, *available at* https://www.ft.com/content/8a88d1e9-8a76-47c3-9fb7-b720fab55f5d.

would thus target solely those who have a duty to get their customers the best executions.

Further, Congress and the SEC should take efforts to promote on-exchange trading activity. The capital markets work best when diverse market participants are able to interact with each other in an open and transparent manner.[51] Investors and public policy should strongly encourage public trading of public securities with transparent pricing.

“Price Improvement” Isn’t What It Sounds Like

We expect the concept of “price improvement” to be heavily discussed at the hearing and in the days that follow. Unfortunately, some have argued and will likely continue to assert that because retail customers may receive “price improvement”, as that term may be currently defined in SEC rules, that those customers are receiving best execution. This claim is often erroneous.

The definition of “price improvement” bears little relation to whether or not a customer actually received the best available price. SEC Rule 605, which requires disclosure of statistics related to best execution, has not kept pace with the modern trading environment. Unfortunately, this allows firms to falsely claim “price improvement” (as defined in Rule 605) when they are, in fact, providing prices that are significantly inferior to those that may be available in the marketplace.

For example, one significant way in which these statistics are misleading is due to the unique treatment of so-called “odd-lot” orders, which are generally orders for less than 100 shares. Historically, “odd-lot’ orders and trades comprised a relatively small percentage of trades, and given their total share volumes, they were generally viewed as not material sources of liquidity nor necessarily essential for measuring market quality. As a result, “odd-lot” orders have traditionally not been included on the SEC-mandated industry “tapes,” also known as the Securities Information Processors, nor are they considered “protected” quotes under Regulation NMS.[52]

What does this mean for investors?

Suppose a retail customer seeks to buy 25 shares of a stock. Suppose further that 25 shares of that stock are available for sale on the New York Stock Exchange for $10 and

[51] Alexander Osipovich, *GameStop Mania Highlights Shift to Dark Trading*, Wall St. Journal, Feb. 12, 2021, *available at* www.wsj.com/articles/gamestop-mania-highlights-shift-to-dark-trading-11613125980&sa=D&source=editors&ust=1613141168498000&usg=AOvVaw0MYdg91ec4AvM0u6J4Nn1P.

[52] Interestingly, while odd-lot trades have been reported in the SIPs for several years, odd-lot orders have not. See *Order Approving the Eighteenth Substantive Amendment to the Second Restatement of the CTA Plan*, SEC, Exch. Act Rel. No. 34-70794, Oct. 31, 2013, *available at* https://www.sec.gov/rules/sro/nms/2013/34-70794.pdf. Odd-lot orders are, however, included in the proprietary data feeds sold by exchanges because, not surprisingly, they are important sources of liquidity for investors of all sizes.

100 shares are available on several exchanges at a price of $10.01. The retail broker may sell the order to a market maker, who then may execute and give it to the customer at a price of $10.0098, claiming that the order received "price improvement" at a rate of 2 cents per 100 shares. However, customer actually received "price dis-improvements." The best available price would have been on the New York Stock Exchange for a whopping 98 cents per 100 shares cheaper.[53] Clearly, the customer didn't get the best available price. The customer did not get best execution.

Alternatively, suppose the market maker did execute the order at the best available price of $10 (which is what we believe should be required by best execution). The broker could be able to claim (based on the current Rule 605 methodology) "price improvement" of a whopping $1.00 per 100 shares, even though the retail customer's execution was not "improved" at all.

A few years ago, when odd-lot trades comprised approximately 20% of the overall market, this was troubling. Today, it is worse. Odd-lot trades now comprise about half of all stock trades.[54] Further, odd-lot orders and trades often comprise even higher percentages of overall orders and trading in high-priced stocks like Amazon or stocks that are widely held by retail investors (like GameStop).[55]

The best bid and best offers on exchanges and other venues are very often odd-lots, but these otherwise accessible quotes are not protected and are ignored when measuring "price improvement" statistics. As a result of this odd treatment of odd-lots, the "price improvement" statistics commonly used by retail brokers and market makers are grossly overstated.

A very recent study examined odd-lot executions in Amazon and GameStop on January 27th, and compared the prices customers in off-exchange trades received, versus the then best prices available on Nasdaq. The academics found that there were approximately one million odd-lot trades for GameStop filled in off-exchange venues

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[53] *See also*, Robert P. Bartlett, III and Justin McCrary, *Modernizing Odd Lot Trading*, at 5, Feb. 16, 2021 (see authors for copy) ("As an illustration, consider a market maker that receives from a retail broker a marketable buy order for a single share when the price-protected NBBO stands at $1,000.00 x $1,000.10. At the time, an odd lot quote to sell 5 shares is also resting on Nasdaq at $1,000.07 and is visible to the market maker through its proprietary data subscriptions. Under Rule 611, the market maker may nevertheless fill the order at $1,000.09, as doing so does not trade-through the protected ask of $1,000.10. Indeed, by filling the order at $1,000.09, the market maker appears to provide $0.01 of price improvement to the marketable order. Yet the trader placing this hypothetical market order would no doubt question whether she received best execution: She would have received superior pricing had the market maker matched the best ask on Nasdaq. This simple example illustrates how even a trade that receives price improvement under Rule 605 may, in fact, receive price dis-improvement.").

[54] Robert P. Bartlett, III and Justin McCrary, *Modernizing Odd Lot Trading*, Feb. 16, 2021 (see authors for copy); *see also* Alexander Osipovich, *Tiny 'Odd Lot' Trades Reach Record Share of U.S. Stock Market*, Wall St. Journal, Oct. 23, 2019, *available at* https://www.wsj.com/articles/tiny-odd-lot-trades-reach-record-share-of-u-s-stock-market-11571745600.

[55] Robert P. Bartlett, III and Justin McCrary.

(like market makers), of which over 20% received prices worse than the best prices available on Nasdaq.[56]

Further, the "price improvement" calculation for those orders using the current regulatory methodology was over $2 million, but if you were to instead factor in the better-priced odd lots available on Nasdaq, the "price improvement" was essentially cut in half.[57] If other exchanges' odd-lot quotes were included, the percentage of trades executed at inferior prices would likely rise, and the "price improvement" would fall further.

We at Healthy Markets have alerted the SEC to these abuses[58] and the need to update Rule 605's reporting requirements to correct this error and eliminate erroneous claims of "price improvement" in these circumstances.

Some have observed that retail brokers who do not currently receive payment for order flow still may route to market makers. Some have further speculated (based on this observation) that even eliminating retail payment for order flow would not change industry practices or benefit investors. This speculation ignores both basic economics and the law.

As for the economics, so-called "price improvement" is negotiated between brokers and their market makers, and often comes at the expense of larger payments for order flow to brokers. A market maker can discriminate and provide "better" and "worse" payments and "price improvement" for different brokers. A broker can also negotiate greater payments for itself, or greater price improvement for its customers.[59] In our experience, market makers are often essentially agnostic, as the money all comes from the same pot. Not surprisingly, we have seen evidence that some firms who receive no or lower payments for order flow have negotiated larger price improvement than brokers who receive larger payments.[60]

As for the law, best execution demands that brokers survey alternative market venues, compare execution quality that could be received, and then adjust their routing practices to obtain best execution. However, to date, US regulators have nevertheless inexplicably permitted retail brokers to route to market makers only. We believe that the retail broker itself, or the broker to which it may route orders, must fulfill its obligation to

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[56] Id., at 16.
[57] Id.
[58] Letter from Tyler Gellasch, Healthy Markets Association, to Brent J. Fields, SEC, Mar. 5, 2019, *available at* https://www.sec.gov/comments/4-729/4729-5020185-182987.pdf.
[59] Prior to launching Healthy Markets Association, we had direct experience with these arrangements. In particular, our Director of Research, Chris Nagy, was previously the Managing Director of Order Routing Sales and Strategy of Trading at TD Ameritrade, where he was involved in the negotiations of payment for order flow arrangements. See also, Michael Lewis, *Flash Boys*, at 180-182 (2014).
[60] Note, these statistics are very difficult to compare apples to apples, and require segmentation by types of product, order type, and more.

scan all competing venues, evaluate potential execution quality, and route orders to where it may obtain the best prices for its customers.

That does not mean scanning only competing market makers. If retail brokers are permitted to route to a single or a small handful of market maker counterparties only, and avoid the infrastructure and compliance costs of developing an order routing system themselves, they will. We are not surprised that retail brokers that have decided to eschew the conflicts of accepting payments are still likely to route to market makers. However, if best execution were enforced, either that broker or any firm to which it routes orders would have to build the infrastructure, and effectively use it to get the retail customers best execution.

Lastly, given that large, institutional orders (in the tens or hundreds of thousands of shares) are now often divided into very small, retail-size increments of two and three-digit share amounts by so-called “smart order routers,” it is clear that the trading technology and infrastructure exist to individually scan the markets, execute, and track best execution for a large number of smaller trades. We see no reason why retail brokers and the market makers who often pay them are essentially permitted to avoid performing these tasks--which are, frankly, core to the business of being a broker (and what many brokers do very well). What is the policy rationale for a selective enforcement of best execution that allows the same hypothetical 77 share order from a retail customer and an institutional customer to be treated so fundamentally differently?

We urge you to consider asking Robinhood whether all of its customers are receiving executions at or better than all quotes, regardless of whether those quotes are odd lots. Similarly, we urge you to ask Citadel whether, when it executes orders for its various broker customers, it ever does not match or beat the best priced order in the market (again, regardless of whether the orders may be odd lots). We would further urge you to seek information about Robinhood’s and Citadel’s “price improvement” statistics, if they used the best available prices as the benchmark, as opposed to the best available round lot.

Customer Protection, Suitability, Gamification, Regulation Best Interests

Many retail brokers are seemingly providing easier access to more complex financial products and more leverage than ever before. At the same time, however, there are questions about whether brokers’ provision of margin accounts and options approval levels are either appropriate or consistent with existing regulatory obligations.

Options trading, in particular, has historically proven to be risky for individual traders. Retail brokers have been aggressively recruiting customers to trade options for many

years, despite the fact the returns for the customers have generally been poor.[61] More recently, and more tragically, it was reported that one young options trader on Robinhood committed suicide after he came to believe that he had an extremely large negative balance.[62]

We encourage you to explore issues surrounding the risks to retail investors from options.[63] One area where Congress and the SEC may start an examination of investor understanding of options trading could be the Options Disclosure Document.[64] The ODD is supposed to be shared with retail customers before they begin options trading.[65]

One significant change we have noticed in recent years is the apparent ease with which customers may obtain access to margin accounts with some retail brokers, versus others.[66] Historically, retail brokers would provide the ODD and demand significant paperwork from potential customers before reviewing, and potentially approving new options trading. More recently, Robinhood has reportedly narrowed this process down to as little as 5 minutes.[67]

At that speed, one has to stop and ask whether the consumer was able to read and comprehend the ODD and the related supplements in that amount of time? After all, the ODD is nearly 200 pages long, and dives into some very complex theory and legalese that is likely incomprehensible to the average person.

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[61] Nathaniel Popper, *Growth in Options Trading Helps Brokers but Not Small Investors,* N.Y. Times, May 24, 2013, *available at* https://www.nytimes.com/2013/05/25/business/growth-in-options-trading-helps-brokers-but-not-small-investors.html.

[62] Matt Egan, *He died by suicide thinking he owed $730,000. Now his family is suing Robinhood*, CNN, Feb. 9, 2021, *available at* https://www.cnn.com/2021/02/09/investing/robinhood-lawsuit-suicide/index.html.

[63] In 2015, the SEC released an Investor Bulletin on Opening and Options Account,but that summary alert is neither sufficiently comprehensive nor up to date. *Investor Bulletin: Opening an Options Account*, SEC, Mar. 18, 2015, *available at* https://www.sec.gov/oiea/investor-alerts-bulletins/ib_openingoptionsaccount.html.

[64] Characteristics and Risks of Standardized Options,

[65] Confusingly, the ODD is from 1994, and is periodically "Supplemented" over time. The most recent supplement appears to be from October 2018. I, Options Clearing Corp., Oct. 2018, *available at* https://www.theocc.com/getmedia/35f73900-f768-42e7-b786-02367df89951/october_2018_supplement.pdf;. Anyone seeking to understand these documents in their entirety would, as a practical matter, have to read all of the 188-page document, and then read each of the iterative supplements and amendments over time. This exercise would likely be profoundly frustrating for even the most patient securities lawyer, but is nearly impossible to ask of an ordinary retail investor.

[66] *See, e.g.*, @TikTokInvestors, Twitter, Feb. 11, 2021, *available at* https://twitter.com/TikTokInvestors/status/1359976699715325953 (comparing approvals on Robinhood (where "it takes five minutes") versus Fidelity (where it may take weeks)).

[67] *See, e.g.*, @TikTokInvestors, Twitter, Feb. 11, 2021, *available at* https://twitter.com/TikTokInvestors/status/1359976699715325953 (comparing approvals on Robinhood (where "it takes five minutes") versus Fidelity (where it may take weeks)).

There are generally four types of options levels for retail traders.[68] Do traders know these levels? Do retail traders understand the risks at each level?

Policymakers and regulators should ask whether retail brokers should be able to default people into margin and options trading accounts. Should brokers be able to "recommend" securities without tripping over "recommendation" rules, for example, by offering “top-ten movers” lists? Put simply, should the easy availability of leveraged trading be revisited?

Another issue that warrants scrutiny is business continuity. Brokers and other market participants are expected to have business continuity plans, and continue operations in times of catastrophic events. What about times of market stress? As we have seen during the recent events surrounding the “meme” stocks, investors lose confidence in the integrity of the marketplace when brokers are unable to keep accepting and directing for execution their orders. In this regard, Robinhood seems to have a significant number of deeply troubling outages,[69] often on busy trading days. These events may leave customers with significant risk of loss, as they may be able to enter trades in particularly volatile markets. What if a Robinhood’s market makers withdraw from the markets due to market turmoil? How could Robinhood continue to operate?

Congress and regulators should also explore trading transparency and the clear herding effects exhibited by retail traders. The current crop of “meme” stocks is just the most recent iteration, but it is not the first. Interestingly, until the middle of last year, Robinhood provided the public with aggregated information about its customers’ trading and holdings. That information, which was then used to populate an unaffiliated website called “Robintrack,” showed extreme risk-taking by large numbers of their customers.[70]

For example, as car rental company Hertz was spiraling towards bankruptcy, Robinhood users piled into the stock in record numbers--despite the increasing likelihood of it all becoming worthless in the nearly immediate future.

In fact, so many retail investors piled into the stock that the company asked the bankruptcy judge to approve of it selling stock as part of its bankruptcy funding plan. A few days and a flurry of public ridicule later, the potential offering was scuttled. The deal wasn’t sunk by a lack of demand for the shares, but because the SEC promised to give

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[68] For a plain-English explanation of options approval levels, please see *Inside Look at Option Approval Levels*, Warrior Trading, *available at* https://www.warriortrading.com/options-trading-option-approval-levels/.

[69] *See, e.g.*, John McCrank and Anna Irrera, *Robinhood trading app back online after major outage*, Reuters, June 18, 2021, *available at* https://www.reuters.com/article/us-robinhood-outage/robinhood-says-experiencing-major-trading-outage-idUSKBN23P30K.

[70] See Robintrack, *available at* https://robintrack.net/ (last visited Feb. 15, 2021).

the offering further scrutiny.[71] Not surprisingly, trading in the bankrupt company's stock was halted on the news.[72]

Getting in front of the retail herd has proven to be a lucrative business for many professional traders, including many hedge funds, and Robinhood itself used to help them by making aggregated data available on its website.[73] However, as Congressional and regulatory scrutiny of Robinhood and its customers grew last year, Robinhood decided to stop reporting its account holdings on its website.

We understand that the company may not want to highlight the herding behavior and extreme risk taking by its customers. But it is a significant loss for those of us who can't otherwise access the data.

By removing the data from the public, Robinhood has also created the potential for an information asymmetry that can be exploited by Robinhood's market makers, and potentially others who may receive information about Robinhood's customers' trading. To be clear, information about Robinhood's retail customers' trading flows is extremely material, non-public information.

To what extent is extremely valuable customer account and trading information available for sale or otherwise to any third parties? How much of that information is shared with Robinhood's market makers to whom it routes orders? Can those market makers use that information to trade for their own profits? What information barriers, if any, are there surrounding the use of that information by other firms? Can a market maker trade on the basis of its confidential knowledge of its retail customer flows? What duty, if any, does a market maker have to not use this information to its advantage?

Lastly, we think Congress and regulators should explore the potential drivers of the exhibited herding and risk-taking behavior by retail customers. For example, are they being driven by "top ten" lists or other nudges or prods? Should regulators establish rules to govern the "gamification" of trading, such as the use of "confetti" and other "game-like" features? What sales practice rules should be updated?

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[71] Claudia Assis, *Hertz pulls share offering, says SEC planned to review it*, MarketWatch, June 17, 2020, *available at* https://www.marketwatch.com/story/hertz-pulls-share-offering-says-sec-planned-to-review-it-2020-06-17.

[72] Claudia Assis, *Hertz stock halted for pending news as as SEC has "concerns" about stock sale*, MarketWatch, June 17, 2020, *available at* https://www.marketwatch.com/story/hertz-stock-halted-for-pending-news-as-sec-has-concerns-about-stock-sale-2020-06-17.

[73] Sonali Basak and Sarah Ponczek, *Hedge Funds Approach Robintrack to Keep Eyes on Tiny Investors*, Bloomberg, July 23, 2020, *available at* https://www.bloomberg.com/news/articles/2020-07-23/hedge-funds-approach-robintrack-to-keep-eyes-on-tiny-investors?sref=DK3y4h9m.

Broker Capital Requirements and Settlement

Leverage is not just a concern for retail investors. It is also important for regulating broker dealers. However, this concern has been underappreciated and inadequately addressed by the SEC.

Unlike capital rules imposed on banking entities by the banking regulators, capital rules for broker dealers are generally neither designed nor intended to prevent a firm's failure. The SEC has generally taken the position that it is agnostic as to whether a broker fails, provided that the customers' assets in the accounts may be eventually protected. In this way, the provisions are intended to reduce the harm to investors if a broker were to fail, but not materially reduce the likelihood of such a failure. This approach (which has persisted despite the collapse of Lehman Brothers during the last financial crisis), inexplicably ignores potential massive secondary ramifications.

Suppose, for example, that a large broker – one with perhaps hundreds of thousands of accounts, many of which may be invested in volatile assets such as low-priced stocks and cryptocurrencies – were to fail. As regulators and lawmakers painfully learned following the collapse of MF Global, protection of customers' assets is important, but so too is the timing of the availability to those assets. We question whether the Securities Investor Protection Corporation (SIPC) and the SEC would be able to ensure that account-holders would have timely access to their assets if a large retail broker were to fail. What would be the potential fallout for other firms in the markets if such a failure took place? Could it trigger other broker failures or market turmoil?

As part of the normal clearing and settlement process, the clearinghouse calculates its risks for settlement. The clearinghouse stands in the middle of securities trades, and so ensures that each trade is finished with an exchange of securities and cash. In times of increased trading and volatility, the clearinghouse may ask its members for additional capital to stand behind the trading (and ensure settlement).

Reportedly, a subsidiary of the Depository Trust and Clearing Corporation (DTCC), calculated settlement risks during the times of increased volatility in the "meme" stocks and determined that it needed to ask its members for additional collateral. This seems consistent with how we might hope and expect the financial market infrastructure to work.

It has been reported that some of their members didn't readily have enough ready capital to meet those calls, which led some retail brokers to reduce or entirely stop their customers' trading, while also scrambling for additional capital to meet the margin call. This, of course, gave rise to not just trade disruptions, but also accusations of foul play. These accusations could be tested by Congress and regulators exploring the circumstances surrounding any margin calls, including whether the clearinghouse

followed its criteria for determining whether to make the calls and the amounts of those calls.

It has been reported (based on comments from Robinhood's CEO), that Robinhood learned of a $3 billion margin call at 6:30 am on January 28th, but after "agree[ing] to implement the trading restrictions, lowering its riskiness according to the DTCC's formulas, the clearinghouse cut its demand to $700 million."[74] On February 1, 2021, Robinhood announced that it had raised $3.4 billion "to fuel record customer growth."[75] It is unclear to what extent this capital raise or any other efforts to secure short-term funding may have been necessary to avoid a potential failure. Obviously, we urge you and regulators to explore Robinhood's capital adequacy, but also those of other brokers during this period. To what extent were brokers or other market participants at risk of failure? What were the risks to those firms, as well as the system overall? What are the risks going forward?

Some have questioned the propriety of the clearinghouse's actions in response to the volatility and increase in trading. While the facts should be explored, we were not surprised that a clearinghouse would respond to a massive spike on volatility and volumes with margin calls. That would be how the system is designed and intended to work.

However, the margin calls do raise policy questions for Congress, regulators, and market participants, including what is the appropriate balance between clearinghouse's "normal" capital requirements and when it may have to engage in margin calls. If, for example, a clearinghouse generally requires more capital contribution from its members on an ongoing basis, then it may be able to avoid margin calls. If it does nonetheless engage in margin calls, they may be less severe. In the past, however, high-speed trading firms (including retail market makers) have resisted calls for more clearinghouse capital. For example, in 2017, they won a case against the SEC, which had approved a clearinghouse rule to increase capital requirements from its members.[76] If the courts will not back the SEC's authority in this area, Congress may need to step in.

There are also questions about the process through which margin calls may be made. Should, for example, margin calls be made during the trading day? What warnings should be provided to the member firms? How transparent and predictable should the process be for members?

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[74] Alexander Osipovich, *Robinhood's GameStop Debacle Spurs Calls to Modernize Stock Clearing*, Wall St. Journal, Feb. 8, 2021, *available at* https://www.wsj.com/articles/robinhoods-gamestop-debacle-spurs-calls-to-modernize-stock-clearing-11612780200.

[75] Press Release, *Robinhood Raises $3.4 Billion to Fuel Record Customer Growth*, Feb. 1, 2021, *available at* https://blog.robinhood.com/news/2021/2/1/robinhood-raises-34-billion-to-fuel-record-customer-growth.

[76] *Susquehanna International Group v. SEC*, No. 16-1061 (D.C. Cir. 2017), *available at* https://law.justia.com/cases/federal/appellate-courts/cadc/16-1061/16-1061-2017-08-08.html.

Some have used this opportunity to publicly campaign for shortening the settlement cycle. We do not think that the settlement cycle was a significant contributor to brokers' difficulties in meeting margin calls or decisions to stop trading.

Nevertheless, in the aftermath of recent events, Robinhood's CEO released a blog[77] and a Twitter thread[78] calling for "real time" settlement. We tend to agree with regulatory experts that have suggested that this settlement cycle discussion seems to be largely a deflection.[79]

That said, the longer the period between the trade and settlement, the greater the risk that the settlement might not happen (because someone can't show up with the money or the securities). In general, shortening the cycle is generally risk-reducing, which is why we were pleased when the SEC shortened the cycle from T+3 to T+2 just a few years ago.[80] The SEC's Investor Advisory Committee "strongly" recommended in 2015 that the settlement cycle be shortened to T+1 for "U.S. equities and other US securities (corporate and municipal bonds, and UIT transactions) as soon as possible."[81] If the US is to remain the leader of the global financial system, it should consider all steps to modernize its payments and settlement systems.

We do not believe that the industry could, as of today, move to "real time" processing. However, we do believe that further shortening the settlement cycle should be explored. We also note that the dominant securities clearinghouse, DTCC, has recently offered suggestions on why and how this should be done.[82]

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[77] Vlad Tenev, *It's Time for Real-Time Settlement,* Robinhood, Feb. 2, 2021, *available at* https://blog.robinhood.com/news/2021/2/2/its-time-for-real-time-settlement.

[78] @vladtenev, Twitter, Feb. 2, 2021, *available at* https://twitter.com/vladtenev/status/1356687248746455041.

[79] *See, e.g.*, @SMTuffy, Twitter, Feb. 2, 2021, *available at* https://twitter.com/IrvingSwisher/status/1356691331402326023 ("Well done everyone, you gave an obvious grifter, with horrible risk and liquidity management, who imperiled his brokerage firm and put retail investors at risk an out.").

[80] See, Press Release, *SEC Adopts T+2 Settlement Cycle for Securities Transactions*, SEC. Mar. 22, 2017, *available at* https://www.sec.gov/news/press-release/2017-68-0.

[81] *Shortening the Trade Settlement Cycle in U.S. Financial Markets, Recommendation of the Investor Advisory Committee*, SEC, Feb. 12, 2015, *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/settlement-cycle-recommendation-final.pdf.

[82] *Why Shortening the Settlement Cycle Will Benefit the Industry & Investors*, DTCC, Feb. 4, 2021, *available at* https://www.dtcc.com/dtcc-connection/articles/2021/february/04/why-shortening-the-settlement-cycle-will-benefit-the-industry-and-investors.

Securities Lending Enhancements and Short Selling Disclosures

Securities financing is the lending of securities (stocks, bonds, asset-backed securities) by one party to another against cash or other securities. There are different types of securities financing transactions, including securities loans, repurchase agreements and sell-buybacks. In 2013, the Financial Stability Board (FSB), a group of leading financial regulators around the world, recommended that regulators obtain "a comprehensive and timely picture of how securities financing markets were evolving and the risks associated with patterns of behaviour in these markets."[83] Indeed, Dodd-Frank Act Section 984(b) directed the SEC to "promulgate rules that are designed to increase the transparency of information available to brokers, dealers, and investors, with respect to the loan or borrowing of securities."[84]

Despite the systemic importance of securities lending markets, despite the Dodd-Frank Act directive to increase transparency in these markets, and despite periodic reminders of the importance of these markets, like the massive short selling and associated securities lending associated with GameStop or securities repurchase agreements ("repo") that were central to the Financial Crisis,[85] or the "repo-to-maturity" trading that contributed to the collapse of MF Global,[86] the SEC has done very little to increase its own or the public's visibility into these opaque, arcane, and systemically important markets. SEC action to enhance its and the public's visibility into securities finance markets (which are not within the scope of the Consolidated Audit Trail) would be a welcome signal that it is evolving its oversight with the challenges of the time.[87]

Further, for short-selling disclosures in particular, the Dodd-Frank Act required the SEC to study short selling disclosures, and the agency received dozens of comments.[88] In

[83] *Strengthening Oversight and Regulation of Shadow Banking*, Financial Stability Board, Aug. 29, 2013, *available at* https://www.fsb.org/wp-content/uploads/r_130829b.pdf.
[84] *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, Pub. L. 111–203 (2010), *available at* https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf.
[85] Frank Byrt, *The Repo Market and the Start of the Financial Crisis*, National Bureau of Economic Research, Dec. 2009, *available at* https://www.nber.org/digest/dec09/repo-market-and-start-financial-crisis ("The financial panic of 2007-8 stemmed from a run on the repurchase or "repo" market -- the primary source of funds for the securitized banking system.").
[86] John Carney, *The Trade That Killed MF Global*, CNBC, Nov. 2, 2011, *available at* https://www.cnbc.com/id/45132384.
[87] We note that the Europeans have recently implemented a Securities Finance Transaction Regulation ("SFTR"). The compliance programs and vendor ecosystem developed in response to SFTR would drastically reduce the cost of an SEC securities finance transaction reporting regime, given that the vast majority of securities finance market participants operate internationally. See *SFTR Reporting*, ESMA, https://www.esma.europa.eu/policy-activities/post-trading/sftr-reporting.
[88] *Short Sale Disclosure: Title IX Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, *available at* https://www.sec.gov/comments/df-title-ix/short-sale-disclosure/short-sale-disclosure.shtml.

June 2014, the SEC offered a report to Congress on short selling disclosures and transactions.[89] That report concluded that "real time" disclosure of short selling wasn't "cost-effective when compared to the baseline." However, the baseline included, amongst other things, a fully operational Consolidated Audit Trail, a goal that has still not been realized.[90]

Many commenters and academics have, for years, petitioned the SEC to update its disclosure rules regarding short selling and short positions.[91]

One way to implement enhanced disclosures of holdings (long or short) could be through Section 13(f). Adopted in 1975, and implemented in 1978, investors are required to make disclosures if they hold more than $100 million in covered "equity" securities. The definition of what is an "equity" security is outdated, and doesn't include a number of financial instruments that it should, such as equity swaps. This allows some hedge funds to avoid reporting holdings, even if they have significant equity derivatives. At the same time, the reports are due 45 days after the end of the quarter. So the reports may be months out of date by the time they are released. We see no technological reason for such an extended delay, as there was when the reporting period was first constructed.

Last year, on a party-line basis, the SEC proposed raising the threshold of equity securities for reporting from $100 million to $3.5 billion, which would have significantly reduced the number of firms making reports.[92] Amidst "almost unanimous"[93] pushback, including from issuers, investors, Members of Congress, and Healthy Markets Association,[94] the ill-advised proposal was dropped.[95]

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[89] *Short Sale Position and Transaction Reporting*, SEC, June 5, 2014, *available at* https://www.sec.gov/dera/reportspubs/special-studies/short-sale-position-and-transaction-reporting.pdf.

[90] We have previously testified before this Committee about our concerns with the slow pace and informational inadequacy of the Consolidated Audit Trail, and will simply note that in the more than three years since that testimony, our concerns have only magnified. *Hearing on Implementation and Cybersecurity Protocols on the Consolidated Audit Trail Before the House Financial Services Committee, Subcommittee on Capital Markets, Securities and Investment*, 115th Cong. (2017) (Statement of Tyler Gellasch, Healthy Markets Association), *prepared remarks available at* https://financialservices.house.gov/uploadedfiles/11.30.2017_tyler_gellasch_testimony.pdf. The CAT is still years from completion, and even then, will lack essential information and precision necessary to properly oversee the markets.

[91] *See, e.g.*, Letter from Joshua Mitts, John Coffee, et. al., to Vanessa Countryman, SEC, Feb. 12, 2020, *available at* https://www.sec.gov/rules/petitions/2020/petn4-758.pdf.

[92] *Reporting Threshold for Institutional Investment Managers*, SEC, 85 Fed. Reg. 46016 (July 31, 2020), *available at* https://www.govinfo.gov/content/pkg/FR-2020-07-31/pdf/2020-15322.pdf.

[93] Ortenca Aliaj and Eric Platt, *SEC plan to cut fund disclosures faces almost unanimous opposition*, Financial Times, Oct. 20, 2020, *available at* https://www.ft.com/content/76be55f3-97ee-4f7b-bba1-b82cdd347d48.

[94] Letter from Tyler Gellasch, Healthy Markets Association, to Vanessa Countryman, SEC, Aug. 28, 2020, *available at* https://www.sec.gov/comments/s7-08-20/s70820-7717968-222993.pdf.

[95] Benjamin Bain and Robert Schmidt, *Hedge Funds' Shot at Keeping Stock Investments Secret Fades*, Bloomberg, Oct. 27, 2020, *available at*

Enhancing disclosures could improve market efficiency and end some wild speculation (and misinformation) about short selling and short positions. Dodd-Frank Act Section 929X(a) modified Section 13(f) to direct the SEC to "prescribe rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the Commission following the end of the reporting period."[96]

Fixing Form 13F reports to include all equity securities, including equity derivatives, and include disclosure of short equity positions could greatly improve market transparency. We also recommend that the SEC itself maintain the list of covered financial instruments itself, as opposed to outsourcing to a venture of the American Bankers Association.

While Healthy Markets does not have an opinion on the appropriate delay in the reporting period, we note that many experts and market participants have argued that the period could be shortened significantly from the 45 days that was originally adopted in the 1970s.[97]

Risks of Discouraging Public Markets and Losing the Forest for the Trees

While you are now exploring many legitimate concerns with the overall health and operations of the public markets, we remind you that public markets are still generally far superior to private markets for investors, the public, and society. When compared to private securities:

- Public securities typically are accompanied by more robust accounting and business disclosure practices;
- Information about public companies, including third party research, is much more readily available and fairly distributed (as required by SEC rules);
- Public securities are far more easily and reliably valued;
- Public securities offer a transparent and efficient method to liquidate shares of common stock;
- Liquidity risks and trading costs for public securities are often significantly lower than for similarly-situated private securities;
- Public securities are much more easily benchmarked, such as against the S&P 500;
- Actual net performance tends to be at least as good, if not better, for institutional investors (and is markedly better for less sophisticated investors); and

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https://www.bloomberg.com/news/articles/2020-10-27/hedge-funds-shot-at-stock-secrecy-fades-as-sec-shelves-revamp.

[96] 15 U.S.C. § 78m(f)(2) (2012).

[97] *See, e.g.*, Letter from Elizabeth King, NYSE Euronext, to Elizabeth Murphy, SEC, Feb. 1, 2013, *available at* https://www.sec.gov/rules/petitions/2013/petn4-659.pdf.

- Public securities generally include far more investor rights and protections.

Despite all the concerns with public markets raised by the events of 2021, these concerns --manipulation, lack of transparency, unfavorable pricing, inadequate protections for investors—are exacerbated in private securities markets.

As we have in the past, we urge the Committee to focus on enhancing the public capital markets as a driver of economic growth and corporate accountability. Simultaneously working to address concerns raised by recent market events will help to ensure they remain the fair and efficient engines of capital formation on which our economic health depends.

Conclusion

Thank you for the opportunity to offer our insights into your important hearing. Please feel free to have your staff contact me with any questions or follow up at (202) 909-6138 or by email at ty@healthymarkets.org.

Sincerely,

Tyler Gellasch
Executive Director