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SEC CHAIR DIRECTS STAFF TO CONSIDER NEW RULES TO MANAGE RISKS HIGHLIGHTED BY GAME-LIKE TRADING APPS

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SEC Chair Gary Gensler testified yesterday before the House Committee on Financial Services about the SEC's efforts to assess and address the market volatility that occurred in GameStop and other "meme stocks" resulting in significant price volatility and trading volume spikes earlier this year.

Gensler said the SEC is working to determine, in the face of changes in technology and finance, how to continue to achieve core public policy goals while ensuring that the markets work for everyday investors. Gensler cited seven factors that were at play during the volatile trading periods:

- **Gamification and User Experience:** Mobile apps expanded access to capital markets, making it easy for investors to sign up, start trading, get wealth management advice, and learn about investing. The apps use a host of familiar online features, such as gamification (points, rewards, leaderboards, bonuses, and competitions), behavioral prompts and differential marketing, to increase customer engagement.
  - Gensler said the staff is preparing a request for public input to consider these issues and determine how to ensure investors using apps with these types of features are appropriately protected and how SEC rules, including Regulation Best Interest, apply in these situations. Gensler noted that many SEC regulations were written well before today's technologies and communication practices existed and need to be re-evaluated to protect the futures, retirements and education of the investing public.
- **Payment for Order Flow:** Gensler noted that in the last few years, most retail broker-dealers stopped charging fees for trades and now instead earn revenue through other streams, including a process called payment for order flow. The two primary kinds of payment for order flow are (i) payments from wholesalers to brokers, and (ii) payments from exchanges to market makers and to brokers.
  - Gensler explained that in the first scenario, retail broker-dealers enter into agreements with wholesalers, which purchase their order flow. Unlike public exchanges that must offer fair

access to their publicly displayed quotes, these wholesalers can decide whether to execute these orders directly or to pass them along to be executed by the exchanges or other trading venues, allowing the wholesalers to get valuable information from this order flow that other market participants get with a delay, if at all. Gensler noted that neither the United Kingdom nor Canada permit broker-dealers to route retail orders to off-exchange market makers in return for payments.

- **Equity Market Structure:** U.S. equity markets essentially have three different segments:
  - Public exchanges like Nasdaq and the New York Stock Exchange, which accounted for about 53% of market volume in January
  - Alternative trading systems (such as dark pools), which accounted for about 9% of trading volume in January
  - Off-exchange wholesalers, which accounted for the majority of the remaining 38%, with only seven wholesalers conducting the vast majority of trading, which Gensler noted raised concerns about whether market structure fair, orderly and efficient markets

- **Short Selling and Market Transparency:** Significant short selling of a number of the meme stocks also led to last January's market turmoil, Gensler said. While FINRA and the exchanges currently publish or make available certain short sale data, Congress directed the SEC under the Dodd-Frank Act to publish rules on monthly aggregate short sale disclosures. In addition, Dodd-Frank provided authority to the SEC to increase transparency in the stock loan market. Gensler said he has directed SEC staff to prepare recommendations for the SEC's consideration on these issues and whether to include total return swaps and other security-based swaps under new disclosure requirements.

- **Social Media:** Gensler noted the January volatile market conditions highlighted the rapidly changing face of social media and its intersection with U.S. capital markets. While acknowledging that online forums can serve as a community, expanding access and market participation, Gensler said he was concerned that wrongdoers will attempt to use these powerful forums to hype certain stocks or manipulate markets. "To be clear, I'm not concerned about regular investors exercising their free speech online. I am more concerned about bad actors potentially taking advantage of influential platforms." Gensler said institutional investors with access to machine learning and data analytics may also benefit from information gained in online communities.

- **Market "Plumbing": Clearance and Settlement:** In January, several broker-dealers decided to restrict customer access to trading in certain meme stocks. Gensler observed that these decisions understandably drew a lot of questions from the investing public, many of whom lost access to the market at a critical time. Gensler said he has asked staff to carefully consider whether broker-dealers are adequately disclosing their policies and procedures around potential trading restrictions; whether margin requirements and other payment requirements are sufficient; and whether broker-dealers have appropriate tools to manage their liquidity and risk.

- **System-Wide Risks:** Gensler also pointed out system-wide risks, including one firm's lack of liquidity to meet margin calls, several hedge funds that lost significant money during the January events, and issues of concentration, whether among market makers or brokers at the clearinghouse.

Gensler said the staff plans to publish a report on these issues this summer and that the SEC continues to vigorously review these events for violations.

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