United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

May 3, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: May 6, 2021, Full Committee Hearing entitled, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Pt. III"?

The full Committee will hold a virtual hearing entitled, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III" on Wednesday, May 6, 2021 at 12:00 p.m. Eastern Daylight Time on the virtual meeting platform, Cisco Webex. There will be one panel with the following witnesses:

- **The Honorable Gary Gensler**, Chairman, U.S. Securities and Exchange Commission
- **Michael Bodson**, President and Chief Executive Officer, the Depository Trust & Clearing Corporation
- **Robert Cook**, President and Chief Executive Officer, Financial Industry Regulatory Authority, Inc.

Overview

On February 18, 2021 and March 17, 2021, the House Financial Services Committee held hearings to examine the January 2021 market volatility stemming from a short squeeze on stocks, including GameStop, AMC, KOSS, and others. More specifically, retail investors on social media site Reddit's "WallStreetBets" subchannel ("subreddit") collectively induced a short squeeze in stocks they identified as being heavily shorted by hedge funds.[1] WallStreetBets users drove stock prices up, forcing short sellers, who bet the stock price would go down, to purchase shares at an increased price.[2] On January 27, 2021, GameStop's stock, for example, closed at $347.51, up from just $3.84 approximately six months prior.[3] Months after the short squeeze, GameStop and its executives have seemingly benefited from the short squeeze. For instance, several departing GameStop executives will, reportedly, leave the company with stock that, as of late April, was worth approximately $290 million.[4] In the same month, the company completed an at-the-market offering, selling 3.5 million GameStop shares for over $550 million in gross proceeds.[5]

During the first hearing, testimony was provided by parties that were directly involved in the January market event. That testimony raised several critical questions regarding the conflicts of interest between payment for order flow and best execution; the sufficiency of short sale disclosures; clearing firm financial requirements and broker-dealer risk management; accelerated settlement; the market dominance of certain participants; gamification of retail investing; the growing impact of social media and technology on America's capital markets; and whether

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[1] The Wall Street Journal. GameStop Stock Frenzy: What You Need to Know (Jan. 27, 2021).
[2] *Id.*
[3] *See* Yahoo Finance, GameStop (GME) History (visited, April 25, 2021)
[4] The Wall Street Journal, GameStop's CEO Is Getting Millions on His Way Out. He's Not the Only One (Aril 25, 2021)
[5] Reuters, GameStop raises $551 mln to accelerate e-commerce push, shares jump (April 26, 2021).

technology has outpaced regulation in a manner that places investors and the market at risk. During the second hearing, an industry participant, an academic, and investor advocates testified regarding various approaches Congress could consider to these market structure issues. During this third hearing, regulators will testify on these same issues within the context of the existing regulatory framework and discuss areas of potential regulatory and legislative changes.

Payment for Order Flow and Best Execution

Payment for order flow (PFOF), essentially, refers to third parties paying brokerages in exchange for brokerages routing customers' orders to the third parties for execution.[6] In December 2000, the U.S. Securities and Exchange Commission (SEC) conducted a "*Special Study: Payment for Order Flow and Internalization in the Options Markets*" which concluded, in pertinent part, that "payment for order flow has had an impact on order routing decisions."[7] The SEC also found that firms with policies to accept PFOF tended to direct orders to specialists who paid PFOF.[8] Firms with policies not to accept PFOF directed orders to specialists who paid PFOF less frequently.[9] Still, twenty-one years after this study, PFOF continues to adversely affect firms' order routing decisions and, in some cases, PFOF has cost retail customers millions of dollars in inferior trade prices.[10]

The SEC's regulatory approach to PFOF has largely involved disclosure requirements aimed at addressing the potential conflicts of interest that PFOF may pose for broker-dealers.[11] Critically, in addition to those disclosure requirements, as mentioned above, retail broker-dealers are also required to get the "best execution" for their customers.[12] This means that if a retail broker-dealer routes customer orders to a market maker, retail broker-dealers such as Robinhood have to make sure the market maker will execute the customer's order on the most favorable terms reasonably available in the market.[13] The retail broker-dealer may not, for instance, route an order based solely on which market maker will offer the most incentives to the broker for order flow. Nonetheless, there is a conflict between a retail broker-dealer's receipt of PFOF, and its best execution obligations. Retail broker-dealers may benefit from submitting a customer's order to the market maker that will pay the most, or to a market maker who will pay PFOF that is higher than PFOF that may be offered by some securities exchanges. This may not always be in the best interest of the customer, particularly with respect to execution quality.

Most securities exchanges also pay executing brokers for order flow, and these payments, often referred to as "rebates," also constitute a form of PFOF.[14] Some have opined that these rebates "exacerbate conflicts of interest between brokers executing trades and retail clients and institutional clients" and lack transparency.[15] In fact, in December 2018, the SEC voted to adopt Rule 610T of Regulation National Market System to conduct a Transaction Fee Pilot in relation to

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[6] *See* 17 CFR § 240.10b-10. PFOF refers to "any monetary payment … or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution...".

[7] *See* Special Study: Payment for Order Flow and Internalization in the Options Markets (Dec. 2000).

[8] *Id.*

[9] *Id.*

[10] *See* SEC Order, In re Robinhood, Admin. Proc. File No. 3-20171 (Dec. 2020).

[11] *See*, e.g., 17 CFR § 240.10b-10; 17 CFR § 242.606; and 17 CFR § 242.607.

[12] *See* FINRA Rule 5310.

[13] *See, id.*

[14] *See* 17 CFR § 240.10b-10.

[15] *See* Recommendation of the SEC Investor Advisory Committee Regarding Exchange Rebate Tier Disclosure (Jan. 24, 2020).

NMS stocks (Pilot).[16] The purpose of the Pilot, was to collect data that would "be used to facilitate an empirical evaluation of whether the exchange transaction-based fee and rebate structure is operating effectively to further statutory goals and whether there is a need for any potential regulatory action in this area."[17] In particular, the SEC sought to determine whether the $2.5 billion in rebates, reportedly paid in 2018, created "...conflicts of interest by incentivizing brokers to send customer orders to the exchanges that pay the biggest rebates rather than to those that would obtain the best results for the end clients."[18] The New York Stock Exchange, Chicago Board Options Exchange, and Nasdaq, Inc. sued the SEC asserting that the Pilot constituted overreach by the government[19] and, in June 2020, the U.S. Court of Appeals for the District of Columbia ruled against the SEC and struck down the Pilot.[20]

Increased Transparency

SEC Rule 13f-1 requires institutional investment managers to file periodic reports if the accounts they have investment discretion over, collectively, have more than $100 million in certain equity securities.[21] Last year, the SEC proposed raising the $100 million reporting threshold for 13f filings.[22] That proposal was met with wide-spread, cross industry criticism for its projected reduction in market transparency.[23] Recent events, including the January 2021 short squeeze, have elicited further industry feedback regarding increased market transparency, including heighted 13f reporting requirements and short sale reporting. Some have called for reforms in 13f filing requirements that would require institutional investment managers to report more frequently than the rule currently requires and would expand 13f reporting to include "short stock sales; [s]hort option positions; and [d]erivatives that mimic the behavior of stocks, such as [t]otal [r]eturn [s]waps…".[24]

Clearing Firm Risk Management and Accelerated Settlement

On January 28, 2021, Robinhood advised that "in light of recent volatility" the firm would restrict "transactions for certain securities to position closing only," including GameStop, Blackberry, AMC and certain other so-called meme stocks, and further advised that the firm would also raise "margin requirements for certain securities."[25] Other brokers also restricted transactions and raised margin requirements.[26] This course of action, which was followed by a decline in GameStop's stock price, became the subject of public scrutiny.[27] Vladimir Tenev, Chief Executive Officer of Robinhood Markets, Inc.,[28] stated that the restrictions were imposed because the firm's clearinghouse, National Securities Clearing Corporation (NSCC), was requiring an additional $3 billion deposit due to its increased risk profile[29] and, as such, Robinhood restricted trading a way

[16] *See* SEC Adopts Transaction Fee Pilot for NMS Stocks.
[17] *Id.*
[18] *See* Big U.S. exchanges to sue SEC over 'overreaching' fee experiment (Feb. 2019).
[19] *Id.*
[20] *See* Financial Times, Court deals blow to SEC in battle with exchanges over fees (June 16, 2020); *see also* NYSE v. SEC, No. 19-1042 ((D.C. Cir.) (June 16, 2020). The U.S. Court of Appeals for the District of Columbia noted that it granted the petitions for review "[b]ecause the SEC acted without delegated authority from Congress when it adopted Rule 610T."
[21] *See* 17 CFR § 240.13f-1.
[22] *See* SEC Proposed Rule, Reporting Threshold for Institutional Investment Managers, Release No. 34-89290; File No. S7-08-20 (July 10, 2020).
[23] *See, e.g.*, CNBC, Jim Cramer Rips SEC's Proposed Rule Change for Institutional Investors (July 22, 2020).
[24] Americans for Financial Reform letter to Allison Herren Lee, Acting Chair, U.S. Securities and Exchange Commission (March 31, 2021).
[25] *See* CNBC, Robinhood restricts trading in GameStop, other names involved in frenzy (Jan. 28, 2021).
[26] *Id.*
[27] *Id.*
[28] *See* Robinhood Markets, Inc. is the 100% owner of Robinhood Financial LLC and the direct owner of Robinhood Securities LLC. *See BrokerCheck* record for Robinhood Financial LLC and Robinhood Securities LLC.
[29] The Wall Street Journal, Robinhood's GameStop Debacle Spurs Calls to Modernize Stock Clearing - WSJ (Feb. 8, 2021).

to manage its risks and reduce its deposit requirements.[30] With respect to the events on January 28, 2021, the Depository Trust & Clearing Corporation (DTCC), NSCC's parent company, noted that:

> NSCC determined that it would be appropriate to waive the capital premium charge for all clearing members.... Just after 9 a.m., prior to the market opening at 9:30 a.m., updated daily margin statements reflecting the waiver were released in NSCC's portal and revised excess/deficiency notices were emailed to clearing members. All clearing members timely satisfied their clearing fund requirements.[31]

Mr. Tenev responded to the events of January 28th by calling for the U.S. to move toward a real-time settlement system which, he says, "would greatly mitigate the risk" inherent in the current settlement cycle.[32] DTCC has also recognized the "immediate benefits of moving to a T+1 settlement cycle," explaining that it "would mean cost savings, reduced market risk and lower margin requirements."[33]

Market Dominance, Leverage and Systemic Risk

Testimony given at the first two GameStop hearings raised concerns about the market dominance of some capital market participants, as well as correlated risks arising from the interconnectedness of certain financial institutions. For example, Citadel LLC is a multi-service hedge fund and financial services company and Citadel Securities LLC, is one of the largest market makers and, according to its website, executes "approximately 47% of all U.S.-listed retail volume."[34] Citadel Securities also, reportedly, handles almost as much trading volume as Nasdaq.[35] Further, Citadel Securities along with market maker Virtu Financial, "account for more of the overall equity market than the New York Stock Exchange."[36] With respect to Citadel, some have raised concerns about a single market maker managing such a large volume of retail order flow, and what that means in terms of pricing.[37] Others have questioned whether Citadel has such dominance in our financial markets that it poses a systemic risk to the entire U.S. financial system.[38]

Citadel LLC and Point72 Asset Management invested almost $3 billion dollars in Melvin Capital Management, a hedge fund that was heavily shorting GameStop stock and, consequently, suffered a 53% loss in January 2021.[39] Melvin's filings reportedly indicated that the hedge fund was highly leveraged before the GameStop frenzy.[40] Just as some market participants were questioning the systemic impact of heavily leveraged hedge funds such as Melvin Capital failing, Archegos Capital Management, a highly leveraged family investment vehicle, defaulted on certain

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[30] Robinhood Blog, An Update on Market Volatility (Jan. 28, 2021), visited April 26, 2021.
[31] DTCC, Letter for the Record to the Honorable Maxine Waters (Feb. 18, 2021).
[32] Reuters. Robinhood CEO Calls for Move to Real-Time Settlement of Trades (Feb. 2, 202)1.
[33] DTCC. Advancing Together: Leading the Industry to Accelerated Settlement. (Feb. 2021). Incidentally, some stakeholders have wondered if Robinhood's focus on accelerated settlement was an attempt to shift industry focus away from how the broker dealer managed financial risk in January 2021.
[34] Citadel Securities Website.
[35] Quartz, Citadel Gets Almost As Much Trading Volume as Nasdaq (Feb. 5, 2021).
[36] *Id.*
[37] Yahoo Finance, Biden's SEC pick: Some crypto markets 'rife with fraud and scams' (March 2, 2021).
[38] The Wall Street Journal, Citadel 'May Pose a Systemic Threat,' Waters Says (Feb. 18, 2021).
[39] The Wall Street Journal, Citadel, Point72 to Invest $2.75 Billion Into Melvin Capital Management (Jan. 25, 2021).
[40] Institutional Investor, Melvin Capital Is Facing Nine Lawsuits Related to the GameStop Frenzy (March 22, 2021)

obligations, leaving prime brokers and commercial banks with significant losses, thereby highlighting the interconnected risks between financial institutions.[41] These events, particularly the lack of transparency into Archegos's holdings, have also caused experts to ask the SEC to improve transparency through expanded 13-f reporting.[42]

Gamification and Social Media

Gamification of investing involves tactics used to increase consumer engagement, time spent on an investment platform, and number of trades.[43] This includes design elements and psychological tools intended to keep the attention of its users, including emoji-filled notifications, prizes, graphics, and animations. The amalgamation of gamification features, such as those seen on Robinhood's platform, has driven criticism that gamified online trading platforms encourage behavior similar to a gambling addiction.[44] Research indicates the more the do-it-yourself investors trade, the worse their financial outcomes are.[45]

There has also been an increase in social media usage discussing investment strategies on apps such as TikTok and Reddit. Investors and their fellow social media users often discuss stocks traded on Robinhood. Certain academics have reflected on these events and noted that "there really is a power in the collectivism happening on WallStreetBets."[46] Still, it is important to consider concerted investment strategies on social media, the potential impact if these concerted strategies reached beyond a few securities and, more generally, if regulators have the tools to adequately assess and respond to the growing impact of technology and social media on America's capital markets.

[41] CNBC, As Wall Street reels, Archegos' fire sale raises big questions about regulation (March 30, 2021).
[42] Americans for Financial Reform letter to Allison Herren Lee, Acting Chair, U.S. Securities and Exchange Commission (March 31, 2021).
[43] The Washington Post. *Robinhood's Role in the 'Gamification' of Investing* (Dec. 21, 2020).
[44] NBC. *Gambling addiction experts see familiar aspects in Robinhood app*. (Jan 30, 2021).
[45] The New York Times. *Robinhood has Lured Young Traders, Sometimes with Devastating Results* (Feb. 2, 2021).
[46] CNBC, How meme stocks like Gamestop and AMC changed Wall Street (April 23, 2021).

Legislation

- **H.R.____, to amend the Securities Exchange Act of 1934 to modernize reporting requirements under section 13(f) of such Act, and for other purposes:** this discussion draft would shorten the reporting period for 13-F disclosures from quarterly to monthly and require the disclosure of short positions and certain derivatives.
- **H.R.____, to amend the Investment Advisers Act of 1940 to limit the exemption provided for family offices from the definition of an investment adviser to those family offices with less than $750,000,000 in assets under management and for other purposes:** this discussion draft would limit the use of the family office exemption to offices with $750 million or less in assets under management and prevent persons who are barred or subject to final orders for conduct constituting fraud, manipulation, or deceit from being associated with a family office.
- **H.R.____, to require the Securities and Exchange Commission to carry out a study on the impact of the gamification of online trading platforms, and for other purposes:** this discussion draft would require the SEC to conduct a study on the impact of gamification of online trading platforms and issue a report within 180 days to the Office of the Investor Advocate and would require the Investor Advocate to review the report and issue recommendations within 90 days.
- **H.R.____, to amend the Securities Act of 1934 to establish certain requirements with respect to retail investor options trading, and for other purposes:** this discussion draft would require enhancements for retail customers who engage in options trading, including preventing broker dealers from offering retail customers monetary and non-monetary incentives that encourage options trading; and would require broker dealers to disclose to customers the percentage of the broker dealer's retail client accounts that lose money on such options trading.
- **H.R.____, to amend the Securities Exchange Act of 1934 to prohibit payment for order flow:** this discussion draft would ban payment for order flow in the form of exchange rebates, as well as payments from market centers to broker dealers.
- **H.R.____, to amend the Securities Exchange Act of 1934 to prohibit trading ahead by market makers, and for other purposes:** this discussion draft would statutorily prohibit market makers from "trading ahead"; require the CEO of each market maker to annually certify that the CEO has performed reasonable due diligence during the reporting period to ensure the market maker has not traded ahead; and would impose personal liability on the market maker's CEO and Directors of the Board if the market maker trades ahead.