Global Counsel

Gensler's SEC will seek a bigger toolbox to confront the GameStop craze… and whatever may come next

Blog post by Global Counsel USA President Erin Caddell and Associate Ben Bassett, 3 February 2021

US financial markets and the mainstream media have been captivated in recent days by the meteoric rise and recent fall in shares of GameStop (ticker: GME), a bricks-and-mortar video game retailer. On its own, the trading in GameStop is not a systemic risk, and is unlikely to lead to a meaningful policy reaction. If, however, last week's events are a harbinger of higher volatility across a broader swath of the US equity market, the incoming head of the Securities and Exchange Commission (SEC) will consider, by choice or necessity, an impactful set of policy responses that could have a big impact on US equity market structure.

Biden's nominee to lead the SEC, Gary Gensler, is no stranger to financial conflagrations. In 1998, as a new deputy at the US Treasury Department following an 18-year career at Goldman Sachs, Gensler was part of a Treasury team that helped coordinate a private-sector bailout of Long-term Capital Management, a highly levered hedge fund, whose losses threatened the health of the broader financial system. Later, as chairman of the Commodities Futures Trading Commission (CFTC) in the Obama administration, Gensler helped draft the Dodd-Frank Act package of reforms in the wake of the 2008 financial crisis, including an overhaul of the derivatives market overseen by the CFTC. Gensler's confirmation hearing before the Senate Banking Committee is likely to be held later this month.

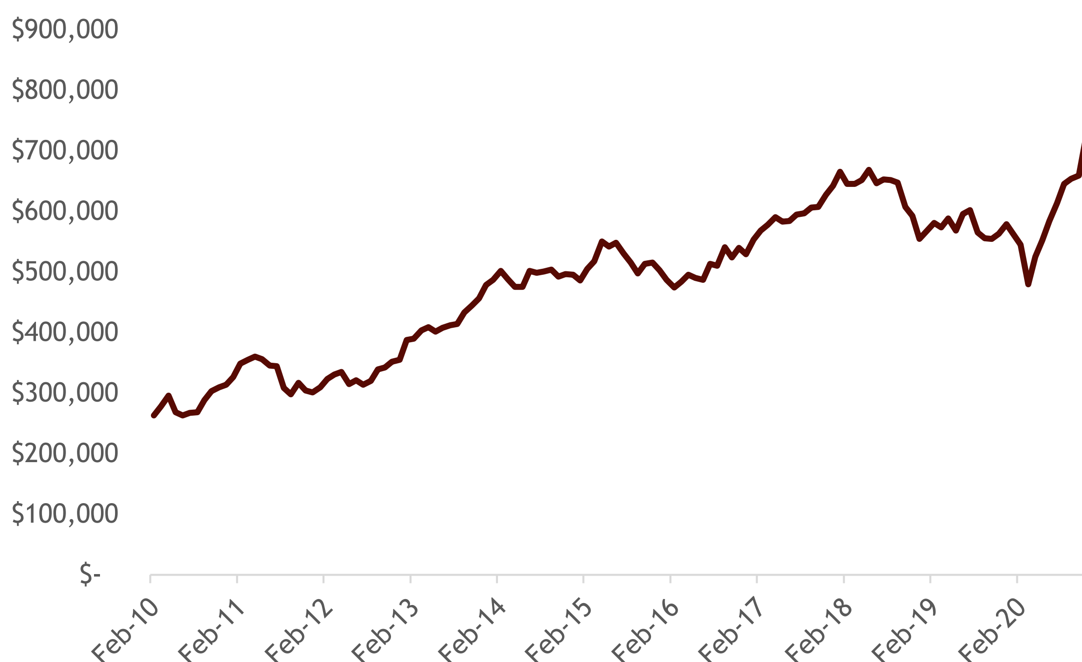
GameStop drew interest last fall from a retail entrepreneur who bought 10% of the shares and put forth a plan to expand its e-commerce capabilities. With the stock moving up on that news, hedge funds came in on the other side to bet the stock would fall. Then, retail investors banding together on online message boards and trading on Robinhood and other online brokers bid up the stock to squeeze the shorts. GameStop shares shot up more than 1,700% in January before falling 70% in just the first two days of February. Other heavily shorted stocks have experienced similar volatility recently.

Washington reacted to the GameStop roller-coaster with a predictable pile-on. The Senate Banking Committee and House Financial Services Committee each announced they would hold hearings on the matter (the House hearing is scheduled for February 18th and will reportedly include Robinhood's CEO as a witness). Treasury Secretary Janet Yellen said she would convene a meeting of regulators.

It is not against the law to attempt to squeeze a short-seller out of a position, nor to post bullish investment calls online (even profane ones). But the GameStop story has become front-page news in part because it is emblematic of speculative excesses that market observers have worried about for some time given the massive monetary and fiscal stimulus applied to the US economy and markets, not just in response to the pandemic, but throughout the post-financial-crisis era. US

investors have taken on some $300 billion in margin debt since the March 2020 lows, increasing the risk of margin calls should stock prices reverse or volume increase (see below).

Debit Balances in US Securities Margin Accounts ($ in millions)



Source: FINRA

What happens if US equity markets stop going steadily up, and instead there is another GameStop, or two, or four, in the months to come, with more lawsuits, more negative headlines? Gensler, empowered by a Democratic president elected in part to protect the "little guy", would look to expand the SEC's power, both to protect investors and to magnify his own agency's impact. "Never waste a crisis," Gensler's former Obama administration colleague, chief of staff Rahm Emanuel, said in exhorting the administration to shepherd Dodd-Frank through Congress in the wake of the financial crisis.

The recent activity in GME and related small-cap stocks will not result in wholesale changes to US equity market structure on their own. But a bigger event or series of events of a similar nature could. With no blame to be cast as his feet for recent events, the risk-reward is in Gensler's favour to seek more latitude rather than less, particularly early in his tenure. This could disadvantage market makers, HFTs and off-exchange venues, while favouring the exchanges themselves.

In a more-volatile market, a Gensler SEC would likely consider several key issues:

1. Payment for order flow - fixed broker rotation and new disclosures possible, though no outright ban. Payment for order flow (PFOF) are fees a brokerage firm receives for directing trades placed on behalf of its customers to a given market maker or exchange for execution. Payment for order flow (PFOF) exists for both common stocks and equity options, the latter generating much higher payments per trade. Payment for order flow is a well-established practice and has essentially subsidised the zero-commission equity trading movement most

closely identified with Robinhood. But the practice drew controversy even before GameStop for its lack of transparency – clients usually do not know where their orders are sent for execution – and potential conflicts of interest. In December 2020, Robinhood reached a $65m settlement with the SEC concerning charges it did not adequately disclose details of its PFOF fees to its customers. The SEC alleged further that, in part because of the incentives PFOF created for Robinhood, investors received poor execution on some of their trades, even taking the absence of a commission into account (SEC rules require brokers to obtain the best possible all-in execution for their customers).

It would be difficult for the SEC to ban PFOF outright given the strength of the argument that the payments help lower costs for retail investors. But the fact that Robinhood receives the highest PFOF rates of any broker by far will certainly be highlighted in the February 18th House hearing, bringing negative attention to the practice. Gensler could propose limits on PFOF (though the SEC's authority to do this has been challenged in court in the past), require brokers to arrange a fixed rotation program among market makers to reduce potential conflicts of interest, or increase disclosure pre- or post-trade.

2. The role of high-frequency trading – an old nemesis for policymakers, with co-location fees a possible target. Media outlets have described the sharp run-up in GameStop shares as a tale of David defeating Goliath: individual retail traders banding together to force monied hedge funds out of a short position. But GME did not become the nation's most actively traded stock by dollar volume in late January just from individual traders. High-frequency trading firms, attracted to the high volume, wide bid-ask spreads and massive volatility, will likely be shown to have played a role. A debate around the role of HFTs in US equity markets, which inevitably flares up after anomalous market events, could return, with an eye toward the advantages HFTs enjoy over individual investors. Case in point: co-location fees, which HFTs pay to securities exchanges so that they may house their computers right next to the exchanges' own, gaining a fraction of a second and a key trading edge over other investors.

3. Off-exchange venues – Bring volume back to exchanges. As he did as CFTC chair in moving some derivatives to clearinghouses from over-the-counter venues, Gensler's SEC could enact changes to move equity volumes from "dark" to "lit" markets, re-establishing at least in part the importance of regulated exchanges. A wave of innovation has swept the US equity markets in recent years, with Alternative Trading Systems (ATS) sprouting up to cater to particular asset classes or types of investors, and regulated as brokers, not as exchanges (ATS' do report their trades to the exchanges). As a result, market shares of the traditional equity exchanges have declined for years as investors large and small have sought out the best price for their trades and trading venues have emerged to cater to new products, from exchange-traded funds to bitcoin. Nasdaq reports that its market share of total matched US equity trading volume was 15% in November 2020, down by half since November 2007; the NYSE has seen a similar trend. The increased competition has led to lower prices and faster execution for investors. But it makes oversight of the markets more challenging. The NYSE

Global Counsel

reported that 40% of trading in S&P 500 stocks occurred in off-exchange venues as of June 2020, up from 34% in October 2019.