February 17, 2021

Chairwoman Maxine Waters
House Financial Services Committee
Washington, DC 20515

Ranking Member Patrick McHenry
House Financial Services Committee
Washington, DC 20515

Dear Members of the House Financial Services Committee,

The recent wild swings in the price of GameStop, AMC, KOSS, BlackBerry, Nokia, and other stocks are shining a light on the growth of retail stock trading and the fragile infrastructure that underlies it. We support the efforts of the House Financial Services Committee to investigate both the events surrounding GameStop's extreme price dislocations and the broader implications for equity markets, investor protection, and concentrations of power in the financial system.

Some key issues that we believe the Committee should investigate and consider include:

- **The role of large Wall Street institutions in GameStop's price volatility.** While retail trading volumes are higher than they've ever been historically, they still make up less than one quarter of the overall market.[1] Many questions remain about the role hedge funds and the flow trading desks of major Wall Street firms played in the GameStop price dislocation. This demands an examination of trading volumes and timing in dark pools and over the counter equity options markets (venues unavailable to retail traders) by large institutions during the recent period of extreme volatility around GameStop trading. This is the first step in examining the footprint of major market participants on GameStop, and important for further investigation of potential market manipulation.

[1] Winck, Ben. (2020, July 9). Retail traders make up nearly 25% of the stock market following COVID-driven volatility, Citadel Securities says. BusinessInsider. https://markets.businessinsider.com/news/stocks/retail-investors-quarter-of-stock-market-coronavirus-volatility-trading-citadel-2020-7-1029382035 ("Retail investors now account for roughly 20% of stock-market activity on average and nearly one-quarter of trades on peak days, Joe Mecane, the head of execution services at Citadel Securities, said in an interview on Bloomberg TV on Thursday.")

- **The transformation of equity market structure**: Two major retail equity market-makers, Citadel Securities and Virtu, combined control more trading volume than NASDAQ and the NYSE.[2] The massive shift in trading volume to Payment for Order Flow (PFOF) arrangements between retail brokers like Robinhood, Schwab, Interactive Brokers and others and large hedge fund-owned market-makers like Citadel and Virtu has potentially profound impacts on equity market stability, trading costs, and price transparency, as well as on conflicts of interest between brokerages and their market makers.

- **The growth in the use of equity options and, more generally, the increase in equity market leverage:** According to DTCC, options trading volume grew by 50 percent from 2019 to 2020, and has expanded even more in 2021.[3] Options are an implicitly leveraged form of trading that expose investors to very large gains or losses for a small initial investment. This can be attractive to those hoping to get rich quickly. But options are high-risk products for investors and, as highly leveraged products, also create additional strains on the stability of equity markets due to volatile margin demands. The move toward greater use of options may be influenced by the lack of enforcement or inadequate design of SEC regulations that create incentives for brokers to push customers into these high-risk transactions.

- **Customer interactions at new retail brokerages such as Robinhood:** New retail brokerages like Robinhood and Tastyworks appear to have brought manipulative practices from social media into customer interactions, including defaulting customers into forms of trading that offer high margins for the broker but may not be in the best interests of the customer, and reinforcing such trading through "gamification" of feedback on the site. This raises fundamental questions about the application of suitability and best interest requirements for broker advice to these new retail brokers, including questions about whether the definition of "advice" needs to be expanded.

- **Prudential regulation of retail brokerages and the clearing process:** At certain points in the run up of GameStop's share price, it appeared that brokerages such as Robinhood that were heavily exposed to the stock faced serious difficulty meeting large and

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[2] Detrixhe, John. (2021, February 5). Citadel Securities gets almost as much trading volume as Nasdaq. Quartz. https://qz.com/1969196/citadel-securities-gets-almost-as-much-trading-volume-as-nasdaq/

[3] The Economist. (2021, January 16). Why everyone is now an options trader. https://www.economist.com/finance-and-economics/2021/01/16/why-everyone-is-now-an-options-trader

unexpected margin calls.[4] This raises questions about what would have happened to investors had these brokerages failed unexpectedly at a time of high price volatility, and whether there is sufficient loss absorbency in the system to protect against the risks of a sudden catastrophic failure of a brokerage.

- **Hedge funds' approach to conflicts of interest and investor disclosures**. Hedge fund firms such as Citadel owned interests in multiple participants in the GameStop-related transactions. The money invested in these transactions belonged to investors, in many cases pension funds. Hedge funds' traditional fee structures could allow the owners of the firm to profit regardless of whether investors in their funds lose money. More investigation needs to take place to ascertain whether conflicts of interest were disclosed to investors and whether these investors had been forced to sign agreements waiving the hedge fund managers' fiduciary duties to investors.

Securities trading is heavily regulated. The Securities and Exchange Commission (SEC) has the regulatory tools to take steps to better understand and control each of the risks outlined above. The Committee should demand that the SEC take action in these areas, including:

- **A fundamental re-examination of regulations around Best Execution and Payment for Order Flow**. During the Obama administration, the SEC asked its Equity Market Structure Advisory Committee if Payment for Order Flow (PFOF) should be prohibited, or if brokers should be required to pass kickbacks obtained via PFOF on to their customers.[5] The Commission identified that PFOF can "create potential conflicts with a broker's duty of best execution and may cause observers to question the rigor with which a broker seeks to obtain the best execution for its customer orders." The Commission should examine if existing regulations need to be changed or updated to avoid harmful unintended consequences. Such consequences could include channeling investors toward risky and unsuitable products such as options or creating relationships between large equity market makers and retail brokerages that involve unmanageable conflicts of interest. International regulators, such as the UK's Financial Conduct Authority (FCA), have already examined the practice of PFOF and decided to ban it in 2012.[6]

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[4] Osipovich, Alexander. (2021, February 8). Robinhood's GameStop Debacle Spurs Calls to Modernize Stock Clearing. Wall Street Journal. https://www.wsj.com/articles/robinhoods-gamestop-debacle-spurs-calls-to-modernize-stock-clearing-11612780200
[5] Securities and Exchange Commission. (2016, January 26). Memorandum to Equity Market Structure Advisory Committee. https://www.sec.gov/spotlight/equity-market-structure/issues-affecting-customers-emsac-012616.pdf
[6] Rosov, Sviatoslav. (2016 June). Payment for Order Flow in the United Kingdom. CFA Institute https://www.cfainstitute.org/en/advocacy/policy-positions/payment-for-order-flow-in-the-united-kingdom

- **Re-examine regulation of retail brokerages.** A re-examination of regulation of retail brokerages to determine if some features of the way they are managing customer interactions (for example, "gamifying" feedback to encourage certain transactions, or highlighting other stocks a customer might be interested in) are violating business conduct standards for brokers or in effect constitute investment advice.

- **Examine broker capital standards.** An examination of market stability and broker solvency in equity trading markets. This should include a re-consideration of broker capital standards and whether they are adequate during extreme market stress, an examination of the potential consequences of a large-scale brokerage failure on investors and market confidence and whether more regulation is needed to prevent such consequences, and whether the clearing and margining process needs reform to address excessive volatility in margin demands.

- **Examine short selling practices and the need for additional information.** An examination of the process for regulating short selling, including whether excessive short selling volumes are permitted, the need for expanding short selling disclosures through Form 13-F, and conflicts of interest created by short selling.

In addition, we believe that the Committee must urge the Financial Stability Oversight Council to revive the interagency Hedge Fund Working Group that was eliminated by the Trump Administration. The Working Group should be re-started with a focus on greatly enhancing oversight and regulation of hedge funds. The ability of hedge funds to pursue speculative trading strategies with no limits on leverage and little if any real transparency into their positions or trading strategies constitutes a clear risk to the markets. The GameStop situation highlights the growing power of major hedge funds as market makers, and it underscores the importance of proper oversight of these firms. Major hedge fund players such as Citadel LLC should be evaluated for potential designation as non-bank Systemically Important Financial Institutions where appropriate.

We thank you for your consideration of these issues.

Sincerely,

Americans for Financial Reform