

February 17, 2021

The Honorable Maxine Waters
Chairwoman
U.S. House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Patrick McHenry
Ranking Member
U.S. House Committee on Financial Services
4340 O'Neill House Office Building
Washington, DC 20024

Dear Chairwoman Waters and Ranking Member McHenry,

The Security Traders Association¹ (“STA”) appreciates the opportunity to provide comments in response to U.S. House Committee on Financial Services February 18, 2021, virtual hearing, “Game Stopped? Who Wins and Loses When Short Sellers, Social Media and Retail Investor Collide.” STA is an organization comprised of individuals who are involved in the trading of financial securities in the U.S and Canada. Our members are employed at retail brokerage firms, agency only broker dealers, asset owners and managers, liquidity providers and exchanges.

Background

The Evolution of Open and Free Markets

The U.S. markets are in a constant state of evolution driven by innovation and at times, new entrants. Throughout the history of U.S. markets, there have been moments when inefficiencies are identified and the evolutionary process proceeds toward an improved market. We believe the events that occurred in late January and early February, 2021, involving the trading of GameStop (GME) are one such moment. We have a marketplace that provides educational resources to millions of investors and enables them to connect and trade with little to no transactional friction. However, the recent events demonstrate more needs to be done towards educating investors, improving efficiencies in market infrastructure and providing greater transparency into certain activities.

While there is still more to learn about the events surrounding trading in GME, STA hopes our initial insights offer constructive contributions to conversations that will ultimately determine the short- and longer-term actions of this committee, the Securities and Exchange Commission (SEC), the Financial

¹ STA is a trade organization founded in 1934 for individual professionals in the securities industry. STA is comprised of 24 affiliate organizations in North America with individual members who are engaged in the buying, selling and trading of securities. STA is committed to promoting goodwill and fostering high standards of integrity in accord with the Association’s founding principle, *Dictum Meum Pactum* – “My Word is My Bond.” For more information, visit <https://securitytraders.org/>.

Industry Regulatory Authority (FINRA), the Depository Trust and Clearing Corporation (DTCC) and the broader industry.

Remarks

Developments in the Markets Benefiting Investors

The democratization of the markets – which has been an overwhelmingly positive, but not new, development – has been at the core of many conversations recently. Among the key drivers for the democratization of the U.S. markets are: low explicit and implicit costs; investment products; and a regulatory regime which protects investors, contributes to the overall integrity of the markets, and provides investor choice. The combination of these factors can be seen throughout the history of the U.S. markets.

In 1975, the SEC ordered the end of fixed commission rates for all securities transactions. While some brokerages tried to maintain existing rates, Charles Schwab created a new kind of brokerage – a discount brokerage that today has over 30 million client accounts worldwide and over \$6 trillion in client assets.

In January 1993, the first exchange-traded fund (ETF) in the U.S. was launched, the Standard & Poor's Depository Receipts (SPY) by State Street Global. This product provided individual investors a basket of assets designed to track an index and was an alternative to mutual funds. At the end of 2020, ETF assets under management in the U.S. topped \$5 trillion dollars. ETFs provide investors the ability to gain investment exposure to equity, fixed income, commodity markets, and foreign markets. Investors who prefer mutual funds have also benefitted from the competitive forces ETFs brought to investment management industry, as well as the intense competition amongst mutual funds which has contributed to expense ratios substantially decreasing.

In the 1998, the SEC approved the Limit Order Display Rule,² and several years later approved the Order Protection Rule (OPR) as part of Regulation NMS.³ The Limit Order Display Rule gives investors the ability to directly advertise their trading interest to the marketplace, enabling them to trade inside the current bid-ask spread and thereby compete with market maker quotations. The OPR protects investors' orders from being traded through and being executed at inferior prices.

In April 2001, under an SEC notice,⁴ all stock markets within the U.S. converted from fractional quoting and trading to decimals. Among the immediate and lasting results of this change has been the narrowing of bid to ask spreads in securities. This has provided an implicit cost savings to individual investors.

While there is debate on the barriers to entry for new broker dealers and investment advisory firms, few will argue that investors are not provided an ample choice of such firms to choose from. According to FINRA,⁵ there were 3,517 FINRA registered firms at the end of 2020. Additionally, the Automated

² <https://www.sec.gov/rules/final/37619a.txt>

³ <https://www.sec.gov/rules/final/34-51808.pdf>

⁴ <https://www.sec.gov/rules/other/decimalp.htm>

⁵ <https://www.finra.org/sites/default/files/2020-07/2020-industry-snapshot.pdf>

Customer Account Transfer Service⁶ (ACATS) is a regulated process which enables investors to move assets from one brokerage to another.

These are just a few examples of a continued willingness of the industry and regulators to democratize access to our markets for all investors while also protecting their interests.

Performance of our markets; market structure

In offering comments on the performance of our markets during the periods of peak volatility in GME, we believe it is best to separate remarks on market structure (the trading of securities) from market infrastructure (the clearing and settlement process of transactions).

Looking at the market structure, the U.S. equity and options markets once again proved to be resilient during this period of heightened volatility and record levels of message traffic attributed to quote and trade information and trading volumes. Unlike March 2020, when the market experienced prolonged periods of heightened volatility across all securities and asset types attributed to the onset of the COVID-19 pandemic, much of the volatility and trading activity during the timeframe in question was concentrated in GME and a small number of other securities. For example, quote updates on GME options averaged more than 500 million per day during this period, a 50x increase. Material increases were also experienced in the number of options contracts traded and trades per day.⁷ This unique attribute of the trading activity did not cause any burdensome stress and the markets functioned properly. Certain ETFs which held GME in their portfolios experienced increased price volatility, but the mechanism for creating and redeeming ETFs was not impeded.

Performance of our markets; market infrastructure

The DTCC and its National Securities Clearing Corporation (NSCC) subsidiary are an essential part of the markets today. Their role is to protect the broader financial system and member firms from the trading defaults of a member firm(s). Maintaining a safe market infrastructure requires well-capitalized clearing members with internal controls to manage risk associated with their trading activity, and expertise in understanding their regulatory net capital requirements and margin requirements from NSCC.

The events of the timeframe raised questions on the effectiveness of the process and transparency with regard to the calculation for determining amounts of collateral clearing firms need to deposit in order to satisfy margin requirements on their portfolio of activity. We believe these questions deserve a response, but this is not the first time they have been raised. The NSCC provides an important role in the functioning of a safe and efficient market; however, claims of a lack of transparency led some market participants needing to deposit additional capital on short notice. Some firms also observed this happening in early 2020 during the onset of the COVID pandemic. Whether inefficiencies or poor transparency exist, or whether there is a disconnect between what NSCC provides versus what industry participants know what is available to them, needs to be understood. Additionally, most brokers only receive margin obligations a few hours before the market opens, which suggests the technology underpinning this function could be improved.

⁶ <https://www.dtcc.com/clearing-services/equities-clearing-services/acats>

⁷ <https://s3.com/gmeoptionsdatajan2021/>

While market participants are able, and should be expected, to operate under this current regime, understanding the inefficiencies in this section of the market – in particular how current rules intended to protect the financial system could in certain situations exacerbate risks – seems prudent to prevent or mitigate against a negative impact in future market-driving events and to ensure the effective use of capital.

A shorter settlement period from the existing T+2 regime would reduce the amount of financial risk in the financial system, which in return would lower the amount of collateral clearing firms would need to deposit with NSCC. It is important to note that in March 2017 the SEC, with support from the industry, adopted an amendment⁸ which shortened the settlement period for securities transactions from T+3 to T+2. During that time, consideration on an even shorter settlement window was discussed, but due to several factors, including a cost and benefit analysis, a determination on T+2 was believed to be the best outcome. Given the market volatility experienced in early 2020 and more recently, it seems prudent to revisit this topic. Competition in this space could also help drive innovation to keep our markets moving forward while continuing to maintain the safety, fairness and efficiency of the market.

Decouple Short term responses from long term

STA supports the efforts of regulators in conducting a rigorous investigation into potential violations of rules and laws. Simultaneously, the regulatory agencies also need to gather data. Our industry and the investors we serve need information. A report described by Treasury Secretary Janet Yellen as “a timely study of the events” would be useful in identifying longer-term issues and possible solutions.

Decouple Entity Specific Issues from Broad Market Structure Issues

As the regulatory agencies gather and make public data their findings, STA believes it is imperative to decouple events and issues which may be specific to one entity or market participant from those which may have industry-wide implications or could represent a market-wide inefficiency. Tremendous progress has been made to democratize our markets in recent years. While we acknowledge that some investors may have been harmed in the events surrounding GME, we believe existing laws and the investigative powers of regulatory agencies will enable them to punish illegal behavior and recoup economic damages if necessary.

The Role of Social Media

Social media continues to play an ever-increasing role in the markets. This should be embraced, but in a pragmatic way. If investors find value on these platforms, then they should be allowed to engage in the online forum of their choice. However, investors who use these platforms need to realize that illegal activity is sometimes propagated on legal platforms. Inquiries by regulators -- whether they are broad in nature about how the platform operates or narrow in regards to potential nefarious activity performed on a legal platform -- are not an indictment on the platform itself or on all of its users. Individuals who violate securities laws need to be identified and brought to justice if they are engaging in manipulative

behavior, whether it occurs via a social platform in the public domain or through some other venue. The regulatory and enforcement agencies will need to reexamine how social media platforms are being used

⁸ <https://www.sec.gov/news/press-release/2017-68-0>

in the marketplace, and we encourage these platforms to work with regulators in a spirit of cooperation in the best interests of investors.

Additionally, it is imperative that individuals registered to practice in the financial services industry, law, accounting and other professions also carry professional obligations outside of their professional activities, including when they engage on social media platforms.

Facilitating Individual Investing

Brokerage firms want to empower investors and make investing easy. Brokerage firms also have a duty to ensure that investors on their platform are provided adequate disclosures, education on investment and trading matters, including the risks and regulation, and a means to self-evaluate their level of financial literacy. Providing educational resources is an area where brokerage firms compete for investors. Brokerage firms invest heavily in this area, and it is a contributing factor in the growth of investing experienced today.

Given the events surrounding GME, we believe more needs to be done towards educating investors and that the report by the regulators could be useful in identifying specific areas. For example, it is important for investors to understand the risks of trading on margin and the transaction rules for cash account established under Regulation T⁹. As regulators conduct their investigations, their findings would help the industry understand if additional education in this area is needed. We also believe the industry will respond accordingly in the area of education and investors will be well served.

Short Selling and Securities Lending

Short selling has received much attention in the events surrounding GME. Questions have been raised, such as how it was possible for the aggregate short position in GME to be roughly 140% of its float, or available shares. While regulators should examine how this came to be, we offer several remarks on short selling and the securities lending practices which facilitate it.

The vast majority of short selling is a necessary lubricant to the smooth functioning of markets. Short selling is done by equity market makers when they facilitate customer purchases. Options market makers who also facilitate customer purchases in options will hedge that position by shorting the underlying security. Arbitrageurs will short stocks and purchase an ETF or index futures that hold the index components if the prices are not aligned efficiently.

Additionally, market participants who believe a company is overvalued will short its shares. Normally, the market depends upon short sellers to sell overpriced stocks and thus help prevent overvaluation. We believe that a difference in opinion between buyers and sellers contributes favorably in the price discovery of a security. Short selling, whether it be in the normal course of a functioning market or to express an opinion on over-valued security, contributes favorably to price discovery and available liquidity.

⁹ https://www.ecfr.gov/cgi-bin/text-idx?tpl=/ecfrbrowse/Title12/12cfr220_main_02.tpl

Regulation SHO¹⁰ was implemented by the SEC in 2005 to govern short sale practices. Regulation SHO requires participants to locate and affirm a borrow in a security before selling it short. This affirmation requirement ensures that the purchaser receives the security on the settlement date of the transaction and that stocks can only be shorted when there are holders willing to loan their stock

Rule 15c3-3 of the Securities Exchange Act of 1934,¹¹ governs securities lending programs which play a critical role in locating and obtaining affirmation of shares. In the event of a broker-dealer failure, Rule 15c3-3 seeks to avoid a delay in returning customer securities -- or worse, a shortfall in which customers are not made whole -- by requiring broker-dealers to safeguard both the cash and securities of their customers. Rule 15c3-3 regulates how a broker-dealer can lend out their customers' shares which were either purchased on margin or paid for in full, and financial institutions that participate in securities lending are expected to have written policies and procedures governing these activities.

The regulatory regime for short selling and the vehicles which support it are meant to protect individual investors while allowing for an integral part in the functioning of our markets to exist. In the case involving GME, regulators should investigate whether these rules which govern the act of short selling and the vehicles which support it were abided by.

Conclusion

The history of the U.S. markets demonstrates a commitment by industry participants and regulators to democratize access to all types of investors. While the events surrounding GME may have harmed certain investors and overall investor confidence, we believe existing laws and the investigative powers of regulatory agencies will address the former and the industry's most likely response to provide greater and improved amounts of education and transparency will address the latter. Finally, even with the market infrastructure inefficiencies that we have identified, firms must operate in a compliant and responsible way so as not to harm investors and the broader financial system. Efforts to improve upon these inefficiencies should be done with the mindset of the benefits they bring to the entire financial market system and the investors we serve.



James Toes
President & CEO



Andrew D'Amore
2021 Chairman of the Board

¹⁰ <https://www.sec.gov/rules/final/2010/34-61595.pdf>

¹¹ <https://www.sec.gov/divisions/enforce/customer-protection-rule-initiative.shtml>