February 18, 2021

The Honorable Maxine Waters
Chairwoman
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Patrick McHenry
Ranking Member
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairwoman Waters and Ranking Member McHenry:

The American Securities Association[1] provides these comments for the Financial Services Committee's February 18th hearing entitled "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide." We appreciate the Committee acting swiftly to hold this hearing on an issue of great importance to investors and our markets.

I. Introduction.

As a general matter, a fundamental tenet of our capital markets is the ability of investors to take risks and invest their own assets as they see fit. We do not believe policymakers should wade into determining the merits of individual investment decisions (i.e. choosing an individual stock v. ETF). This would contradict the mission of the Securities and Exchange Commission (SEC) and has been consistently rejected by Congress since the passage of the securities laws eight decades ago.

As is almost always the case, the issues raised by the recent volatility in GameStop (GME) are complex and interrelated. In short, the recent trading in GME represents a classic "short squeeze" which has happened in the past and will happen again in the future. As Congress and the SEC investigate the connection between technology, short sellers, and the financial markets, we believe a few issues deserve further scrutiny and have laid them out on two pillars below: (1) investor protection and (2) safety and soundness.

II. Investor Protection.

A. Customer Protection and the Gamification of Trading**:** A quote from a recent Netflix documentary, *The Social Dilemma,* asserts that "[i]f you're not paying for the product, then you *are* the product!"[2] In this case, the product is the customer's trade, and the business model is

[1] The ASA is a trade association that represents the retail and institutional capital markets interests of regional financial services firms who provide Main Street businesses with access to capital and advise hardworking Americans how to create and preserve wealth. The ASA's mission is to promote trust and confidence among investors, facilitate capital formation, and support efficient and competitively balanced capital markets. This mission advances financial independence, stimulates job creation, and increases prosperity. The ASA has a geographically diverse membership that spans the Heartland, Southwest, Southeast, Atlantic, and Pacific Northwest regions of the United States.
[2] *The Social Dilemma*. Directed by Jeff Orlowski, Argent Pictures, 2020. *NetFlix.*

predicated upon generating as much trading as possible and then selling those trades for profit. So, while customers are told they can trade for 'free', the reality is a little more complicated.

1. What's Really Going on Here. Without a doubt, trading applications have made investing easier and more accessible for investors. As their popularity and use grows, it seems fair to ask whether certain types of trading apps raise investor protection concerns. One question we have is whether a trade executed from a "self-directed"[3] account on a trading app can actually be a solicited trade. More specifically, is it a trading recommendation when a firm uses an interactive artificial intelligence algorithm to target the behavioral characteristics of its customers to urge them to execute a trade on the app? Does the answer to that question change if the firm has a business model that depends on its customers executing orders on the app so it can receive payment for selling those orders to a third party?

FINRA raised these exact concerns in its 2021 Report on Examination and Risk Monitoring when it asked "[i]f your firm offers an app to customers that includes an interactive element, does the information provided to customers constitute a 'recommendation' that would be covered by Reg BI, which requires a broker-dealer to act in a retail customer's 'best interest', or suitability obligations?"[4] We believe this is another important question to explore during this hearing and the discussions that follow.

2. The Interactive App. Certain mobile applications used by retail investors seem to be blurring the lines between what constitutes solicited and unsolicited orders. Utility trading apps provide a simple platform to allow customers to access quotes and enter trades without help. Interactive trading apps include these basic functions, but they also integrate artificial intelligence algorithms that learn about their customers behavior. This is designed to send them targeted alerts about specific stocks based on their previous trading habits and inform them about what other platform users are buying and selling, among other things.

The interactive trading apps employ many of the features used by social media platforms designed to promote specific outcomes. They have the look and feel of a game with promises of "free" stock, constantly updated "top movers," and congratulatory graphic displays when accounts are opened. And, once a customer clicks "buy" or "sell", the apps employ features such as confetti to celebrate the execution of the trade. This element of celebration is designed to give the customer an "addictive high" in the same way the 'like' button on social media applications keeps the customer on the app, scrolling incessantly, and coming back for more.[5]

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[3] A "self-directed" account is one where investors can place an "unsolicited" order for a security without receiving a recommendation from a registered representative (i.e. the customer pulls information from the firm's analyst reports, its market reports, or other outside sources before making an investment decision). When an unsolicited order is received, firms document that the order was placed by the customer without any of its associates having provided advice to the customer in connection with the order. The SEC has recognized the value of allowing customers to utilize self-directed accounts by exempting unsolicited customer orders from certain regulations. New technology has allowed investors to easily open a variety of different "self-directed" brokerage accounts to execute trades on their smartphones. We support this.

[4] https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/communications-with-public

[5] https://wentworthreport.com/2017/12/12/why-facebook-is-so-addictive-the-like-button/; https://www.independent.co.uk/life-style/gadgets-and-tech/facebook-inventor-deletes-app-iphone-justin-rosenstein-addiction-fears-a7986566.html;

The interactive app's use of game-like features seems to serve no other purpose than to stimulate as much trading by customers as possible while they are logged in.[6] So, it is not an exaggeration to say that customers are made to feel as if they are being 'sold' certain stocks while using it.

B. Customer Protection Rules and the Interactive App. As Congressman Jim Himes recently said "[t]he idea you're going to be a responsible investor by regularly trading via your device is just plain wrong, and a lot of people are going to get hurt by that idea."[7] We agree, which is why we believe the popularity of 'free' interactive trading applications should be carefully weighed against the importance of investor protection.

In our view, when a registered broker-dealer has a business model that uses an interactive algorithm designed to encourage the execution of customer orders so it can sell those orders to a third party for profit, then policymakers should ask the following questions: (1) is an account under this model really "self-directed'; (2) should the solicitation, Regulation Best Interest, churning, and other customer protection rules be applied to the algorithm carrying out the "recommendations" under the model; and (3) is it appropriate for the firm to offer retail customers with little-to-no trading experience the ability to leverage their accounts by trading on margin.

III. Safety and Soundness.

A. Broker-Dealers Must be Properly Capitalized. Properly capitalized clearing members and clearinghouses are fundamental to protecting the broader financial system. Brokers who are not properly capitalized for the volume or the volatility related to the trading they handle will experience liquidity problems if the market moves against them.

When a firm lacks the capital necessary to meet its financial obligations to the clearinghouse that settles its trades, its management may be forced to take drastic measures such as preventing its customers from continuing to trade and raising emergency capital. While such actions may outrage the firm's customers, no single firm can be allowed to threaten the viability of the clearinghouse or its members. As the GME short squeeze unfolded, the clearinghouse recognized that an inadequately capitalized broker-dealer could pose a risk to our markets and it took the action necessary to protect the system.

Attempts to blame the clearinghouse or the timing of the settlement cycle for what happened during the short squeeze are a smokescreen designed to obfuscate the concerns raised in this letter.

[6] Alter, Adam, Irresistible: The Rise of Addictive Technology and the Business of Keeping Us Hooked, Penguin Books, 2018.
[7] "Fintech's bid to 'democratize finance' dealt a blow by GameStop frenzy", Victoria Guida, February 15, 2021 https://subscriber.politicopro.com/financial-services/article/2021/02/fintechs-bid-to-democratize-finance-dealt-a-blow-by-gamestop-frenzy-2034794

B. Regulation SHO & Stock Lending. Our basic question is how can a company's stock have a short position of 140% of the shares outstanding? University of Georgetown Professor James Angel simply describes it like this, "the same shares can be lent over and over again."[8]

When this happens repeatedly, the level of short interest in a company becomes excessive. As this occurs, the stock becomes susceptible to a short squeeze. A short squeeze happens when traders decide to quickly exit their short positions by buying the shares of the company with the high short interest. This rush to buy forces the price of the stock to catapult higher.

A short squeeze can create volatility that impacts the fair, orderly, and efficient functioning of the market. In the case of GME, this is what happened. But the increase in price volatility was not confined to GME alone, it spread throughout the equity market to every mutual fund and ETF that held a position in GME.[9] This is how retirees, pensioners, working families, and mom-and-pop investors who didn't know they owned GME were impacted during the trading frenzy.

The next question to ask is whether there is any social good in allowing the short interest of a company's stock to exceed 100% of its shares outstanding, and if the answer is no, then we recommend that Congress and/or the SEC should thoroughly examine the details of the Reg SHO delivery rules[10] and the mechanics and pricing of stock lending arrangements.

A thorough examination should (1) determine whether "naked" short selling is still occurring in the market, (2) review the delivery exemption for market makers, which effectively allows them to fail indefinitely, (3) examine whether Reg SHO, which requires those who are short to buy back the stock at any price, contributed to and exacerbated market volatility, and (4) explore whether the re-hypothecation of shares through stock lending arrangements (hard-to-locate or not) and the costs associated with such arrangements should be transparently disclosed to all market participants.

IV. Other Matters to Consider.

A. Transparency in Short Sales. While short selling is a longstanding and necessary market function, it can be subject to certain abuses that harm investors. We have three simple recommendations to improve market confidence and help to level the playing field for all investors:

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[8] Angel, James J., Gamestonk: What Happened and What to Do about It (February 8, 2021). Available at SSRN: https://ssrn.com/abstract=3782195. Example Here: "Short sellers need to borrow shares in order to deliver them to buyers. Suppose that Shareholder #1 owns 100 shares. Shareholder #1 is more than happy to take some money from the short sellers by renting out the shares to Short Seller A. Short Seller A sells the borrowed shares to Shareholder #2. Likewise, Shareholder #2 is happy to take money from short sellers by renting the shares to Short Seller B. Short Seller B sells the shares to Shareholder #3. Shareholder #3 does not lend out the shares. Notice that in this example there are 300 shares of long positions (Shareholders 1,2, and 3) and 200 shares of short positions (Short sellers A and B), but only 100 actual shares".

[9] https://www.thestreet.com/etffocus/market-intelligence/etfs-gamestop-frenzy "XRT only rebalances on a quarterly basis, so there's no real mechanism for adjusting in between those dates (unless the fund wants to do a special rebalance, but those instances are rare). As a result, GME accounted for about 20% of the fund at its peak."

[10] https://www.sec.gov/investor/pubs/regsho.htm

(1) SEC Form 13F should include disclosures of institutional holdings of short positions in the same way it does for long positions (this does not harm short sellers because if they are right, then they will be rewarded for their hard work by entering the short first);
(2) aggregate short interest for each equity should be publicly reported weekly or daily, rather than monthly (this information is readily available and calculable today); and
(3) end the existence of "short and distort schemes"[11] by prohibiting the publication of short reports on specific companies by any person or firm that holds an existing short position in such company.

B. Margin Transparency. As it relates to the market turbulence in March 2020, the Bank of International Settlements said that it happened, in part, because clearinghouses issued large margin calls based on models that did not properly account for a period of *prolonged market-wide* volatility.[12] The best way to avoid this in the future would be for market participants to better understand how clearinghouse volatility models work so they can plan appropriately.[13]

IV. Conclusion.

America's capital markets can play a vital role in closing the wealth gap in this country, which is why we must work together to maintain the public's trust and confidence in them. The ASA looks forward to being a resource as you work through these important issues. Please contact me directly if you have any questions and thank you again for holding this hearing.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
Chief Executive Officer
American Securities Association

[11] SEC.gov | SEC Charges Hedge Fund Adviser With Short-and-Distort Scheme This is harmful to capital formation as those who do it typically prey on small public companies, harming their employees and investors.
[12] https://www.bis.org/publ/bisbull13.pdf, BIS Bulletin No. 13, "The CCP-bank nexus in the time of Covid-19" May 11, 2020. In particular, the BIS bulletin said that "[t]he procyclicality of leverage embedded in margining models might have played a role in the events of mid-March. These margin models are critical because they underpin the management of counterparty credit risk. Margin models of some CCPs seem to have underestimated market volatility, in part because they have relied on a short period of historical price movements from tranquil times. These CCPs had to catch up and increase margins at the wrong time, squeezing liquidity when it was most needed."
[13] It would be useful to know the parameters of what will trigger an increase in a capital contribution from clearing members and what levels of volatility will cause different percentage increases in margin. This could take the form of disclosure by the clearinghouses to the SEC in a table format that could be easily accessible on their websites.