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GAMIFICATION OF STOCKS: HOW CAN THE SEC ACT?

*In late June, Wall Street Lawyer spoke to Amy Lynch, president and founder of the consulting firm FrontLine Compliance, on the topic of "meme stocks" and how the Securities and Exchange Commission may act to try to regulate them. Lynch has worked for the SEC in its New York and Washington, D.C. offices and was a special investigator with FINRA. She has also worked as the DOC for Mercantile Capital Advisors, as Chief Compliance Officer for E*Trade Advisory Services, and as vice president at RegEd.com.*

Wall Street Lawyer: *In terms of addressing the "gamification" of stocks, what options can the SEC pursue? What are some likely scenarios for them?*

Amy Lynch: Chairman Gensler has said publicly at conferences and when appearing before Congress that he's having his staff look into this. And that's good. We should start with definitions. The term gamification needs to be defined: what does that mean, really? What are these platforms that have been named in the recent frenzies, the very online trading platforms like Robinhood, these systems that provide a mechanism for trading? They are registered as broker/dealers but they market themselves as an app for your phone that you can easily go to and conduct securities transactions. They market heavily to younger people that are major users of mobile phone apps, and of gaming in particular on mobile devices.

So, they're using techniques that are often found in gaming—giving an instant reward for conducting a trade, such as the confetti that comes down on the Robinhood app whenever you place a trade, for instance (which has since been removed by Robinhood). Another mechanism on Robinhood is that they'll have users vie to be first in line to get access to a new product, so they have to keep clicking on a page or button. Things like that are essentially gamification techniques. That's what I think the SEC will be looking at—these apps and how they function. What they're worried about is: are they inciting or inducing people to trade heavily in their accounts? Because studies have shown that frequent trading often costs the trader more in transaction-related fees or other losses than if they were simply buying and holding securities. The SEC is going to look at the functionality of these systems and if these are inducing trading. But I think that's going to be a hard thing for them to determine.

WSL: *One thing Chairman Gensler has suggested was for the likes of Robinhood to issue pop-up disclosures, basically issuing warnings before someone can make a trade on an app.*

Lynch: Those kind of pop-up disclosures already occur in many trading platforms when transactions are placed. These mechanisms are there for other reasons, so it would be fairly simple for providers to do that. A pop-up that showed the risks and downfalls of frequent trading, perhaps after x number of trades in an account in one day, may be one way the SEC can effectively address the issue, by requiring disclosures to make sure users do understand the risk they face by conducting frequent trading.

WSL: *Are there other gamification-related areas that the SEC is currently examining?*

Lynch: There's already been a lot of debate on the blowup that happened in January and what resulted from that. We had hearings, we had Citadel under the gun, Robinhood was under the gun, Reddit was under the gun. Everyone was asking questions. The trading had gotten so off the charts with GameStop that it had repercussions within the actual systems that basically execute transactions, [showing a] general weakness within the whole market structure around how trades take place. Chairman Gensler has already mentioned he's going to take a look at that. Many people would love to get us to at least a T-plus one if not T-plus zero settlement cycle because that reduces the risk to clearing firms. That clears up the plumbing, gets the blockage out by shortening the lifespan of the trade.

WSL: *Another of the Chairman's recent comments was about considering new rules around market structure, such as a ban of payment for order flow, as seen in Canada and Australia. Is that possible?*

Lynch: I think [the SEC] is going to take a look at payment for order flow again, but first they're going to conduct their studies, look at firms that conduct trades mainly via that practice, and see what kind of executions clients are receiving in those trades. I've noticed recently some interactive brokers have commercials about payment for order flow. They're basically telling their customers you have a choice: you can either pay zero commission and be part of the payment for order flow system, or pay a fee and IBKR will aggregate your order with institutional customers. They're giving their retail clients a chance to trade alongside their larger institutional accounts. I think you might see more of that. Due to the bad publicity around payment for order flow lately, the industry may find its own fix.

WSL: *Anything else to keep an eye on in the near future?*

Lynch: Keep in mind that app trading is a good thing if it means that having a brokerage account is now more accessible to the average person; it's a good thing to have accounts with low minimums, no fees or charges, easy transactions—just a few shares here and there. This allows younger people and people with lower incomes to participate in the market, and that's going to generate wealth.

But what's happening with the meme stocks is something the SEC needs to figure out: what's really going on here. That's why they're looking at GameStop, looking at AMC—they need to find out if there are bigger market structural issues behind what we're seeing. If it really is just a bunch of people on Reddit, "average joes" taking advantage of their social media and online skills and being able to move the price of a security, that's fine. But the SEC needs to see if there is something more untoward happening here, if there's been any kind of front-running by insiders or if hedge funds are masquerading as Redditors.

They need to find out who the real players are. I have to say: for me, someone who's been in the industry on a regulatory compliance side for over 25 years, it does look suspicious. It seems like it would be very hard to get that many true retail traders to band together and act as one, even with social media, to all trade together like that, to move a stock that quickly that fast, up 1,000%. That's a bit unbelievable for the retail side of the world. It's why I think the SEC may find there's something else moving these stocks—once they determine that, they can say, 'this is what happened, here's how it happened' and then they can try to find a solution. Because it will continue until they find a fix; it's going to keep happening.

WSL: *How would they find this out, by trying to figure out who's really saying what on message boards?*

Lynch: They can find out which hedge funds were involved. They know who the big short sellers are. They get tons of market data and transaction data sent to them every day for thousands and thousands of trades. To figure out who's behind the trades— that's the hard part. They have to back into it. The Reddit side of it is all anonymous, people using handles, and you could be one person and literally have 100 different handles. They need to find out if there are bot programs on these platforms. There's a lot to dig into, it gets very technical and that's a problem for the SEC—they're not that technologically savvy. The SEC may need to get help to figure this out, by using contractors who are experts at determining this type of internet activity and who could better figure out what is behind it.