Katten

ADVISORY

Market Trading Trends: Expect Regulatory Guidance to Accelerate

November 24, 2021

Gamification tactics and investment advice from social media influencers and chat rooms are just a couple of the disruptive technologies and behaviors that are capturing the attention of regulators in 2021 and forcing them to take a closer look — and react. For the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission (SEC), the question becomes how far this new generation of traders should be allowed to take advantage of these new tools, apps, and free trades, and what guardrails need to be in place to protect investors and ensure market integrity? The consensus is that we can expect regulatory guidance to accelerate in 2022.

During the market trading "hot topics" panel at Katten's annual Financial Markets Litigation and Enforcement Symposium Series, Katten attorneys discussed developments in best execution and payment for order flow, disruptive technology, a new generation of traders, and the most highly controversial activity of the year, the GameStop trading frenzy.

Five Takeaways to Note

1. A New Generation of Traders and the GameStop Frenzy

In 2020, one clearing firm reported opening six million new accounts, a 137 percent increase over 2019. One million of those new accounts were from Generation Z with an average age of 19 years old. With so many more people interested in market trading, and a significant number of whom are taking guidance from social media, it should be no surprise that 2021 delivered some unexpected developments. Among them was the GameStop trading frenzy fueled by social media platforms and socioeconomic undertones.

On the Reddit internet chat board "WallStreetBets," retail investors reveled in the knowledge that GameStop, a dying breed of brick and mortar video game stores, was shorted heavily in 2020 and vulnerable to a short squeeze. Wanting to "stick it to" hedge funds, Wall Street, and the "1%," these new investors encouraged each other to buy the stock and push it up further. The activity caused a massive price surge — up 928 percent — during the first few weeks of 2021 and effectively forced short sellers, including large hedge funds, to remove their short positions and buy shares. In turn, the run-up led to unprecedented market volatility and resulted in some significant losses for large investors.

In the wake of the GameStop run-up, clearing houses and brokerage firms began pointing fingers at one another. But an October 2021 report issued by the SEC after congressional hearings on the matter concluded that the price surge was in fact caused by a large group of individual retail investors taking cues from social media. Although the report did not make specific policy recommendations, regulators are expected to eventually respond.

2. The Dubious Role of 'Fin-fluencers'

Following in that same vein, 2021 saw a significant uptick in the number of social media influencers entering the financial space. In general, social media influencers have established credibility in a specific industry, have access to a huge audience, and can persuade others to act based on their recommendations. Though influencers have been around for some time, financial influencers are fairly new.

“Fin-fluencer” social media activity runs the gamut from pitching stocks on the rise and how to get-rich-quick schemes to sharing educational material or personal stories. On the up-side, some believe fin-fluencers fill a gap in financial literacy, despite most lacking formal qualifications. On the downside, there is a lack of transparency regarding risks associated with products and investment strategies they recommend and the potential for pump and dump schemes.

Further, with fin-fluencing growing, more firms are adding them to their marketing mix. There is no better way to reach the new generation of traders than through social media. Firms and broker-dealers are using (and paying) fin-fluencers to talk about stocks and services on their behalf. Regulators are now looking into broker-dealer practices and have issued requests for information, asking for a detailed history of relationships with influencers, how they first identified them, how they are compensated, and any referral agreements they may be engaged in. The inquiry letters also give several pages to privacy concerns regarding sharing client information with influencers. This is certainly a ripe area for more regulation and guidance in the near future.

3. Gamification

Closely related to fin-fluencing and chat room investment advice is gamification, also known as digital engagement practices. Similar to a fitness tracker, investment apps using gamification tactics can track the individual's trading activity and encourage trades, sends alerts, use a leaderboard and reward the user with badges when they reach certain milestones. The regulatory issues involved are numerous. For example, is an app that encourages an investor to trade considered a broker recommendation that falls under regulated activity? We expect FINRA and the SEC to issue more guidance on gamification in the near future.

4. Best Execution Requirements

FINRA's 2021 Regulatory Notice 21-23 provided specific guidance on Payment for Order Flow (PFOF) and Best Execution requirements. One observation is that FINRA stakes price as the primary consideration, above the many other criteria, for evaluating execution quality. Meanwhile, SEC Chairman Gary Gensler recently sent a directive to staff to consider whether additional best execution requirements or guidance are needed to promote investor protection which hints at possible additional best execution requirements to come.

5. Payment for Order Flow

PFOF, which over time has survived calls for banning the practice, faced a new push that would include rule changes or barring the practice altogether in 2021. Calls for review followed the uproar and market volatility created by the GameStop episode. While the connection between the GameStop saga and PFOF isn't clear cut, in October, SEC Chairman Gensler said that the agency is indeed looking into whether PFOF should be changed or barred, with the objective being to create a more competitive marketplace.

Drawing additional scrutiny in 2021, is the growth in size of payments connected to retail order flow. During the first three quarters of 2021, PFOF grew by 41 percent compared to the same period in 2020. A large percentage of that increase is tied to options trading which has increased over 25 percent, in large part due to the increased number of retail investors trading options. Regulators are concerned brokers are encouraging retail investors to jump into these risky complex derivative markets without understanding the risk. Commissioner Gensler suggested there could be two potential rulemakings in the near future, one for investment advisors and another for broker-dealers.

Read more coverage from the 2021 Annual Financial Markets Litigation and Enforcement Symposium Series:

The State of Futures: Emerging Trends and Enforcement Priorities

Securities Regulatory and Enforcement: Four Asset Management Trends

Global Financial Institutions Legal Departments Share D&I Successes and Lessons Learned

CONTACTS

For more information, contact your Katten attorney or any of the following attorneys.

Susan Light
+1.212.940.8599
susan.light@katten.com

Michael J. Lohnes
+1.312.902.5341
michael.lohnes@katten.com

Patrick M. Smith
+1.310.788.4444
patrick.smith@katten.com

Alexander C. Kim
+1.212.940.6535
alexander.kim@katten.com