**american securities association**

*America's Voice for Main Street's Investors*

September 30, 2021

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 2049

**Re: Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice (Release Nos. 34-92766, IA-5833; File No. S7-10-11)**

Dear Ms. Countryman:

The American Securities Association (ASA)[1] is pleased to provide comments for the Securities and Exchange Commission ("SEC") request for information regarding the use of digital tools by broker-dealers and investment advisers and the "gamification" of digital trading applications targeted at retail investors. ("Request") The ASA appreciates the ongoing attention of the SEC to the timely and critical investor protection issues discussed as part of the Request.

As a general matter, a fundamental tenet of our capital markets is the ability of investors to take risks and invest in assets as they see fit. As a result, the SEC must avoid regulating the merits of individual investment decisions (i.e. whether an investor chooses an individual stock versus an exchange-traded fund). Merit-based regulation would contradict the mission of the SEC and has been consistently rejected by Congress since the passage of the securities laws eight decades ago.

However, the SEC does play an important role in applying the consistent application of its rules to registered investment firms. True investor empowerment and democratization includes ensuring investors have the tools and information they need to make smart decisions; it does not include treating investors as algorithmic inputs and continually sending them digital nudges to trade whatever the stock du jour may be. Thus, we think the SEC role in protecting retail investors should include- at the very least- a thorough examination of business models that use predictive analytics to incentivize frequent trading and risk-taking.

[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 of almost one hundred members located in every region of the United States.

The Request focuses specifically on the digital engagement practices (DEPs) used by certain broker-dealers to engage and communicate with retail customers. The Request notes that "[digital engagement practices] can potentially harm retail investors if they prompt them to engage in trading activities that may not be consistent with their investment goals or risk tolerance."[2] It further notes that DEPs may also employ "dark patterns" that are specifically designed to confuse customers or entice them to take certain actions with respect to trading. The ASA shares many of these concerns and we support the request for further information to help the SEC determine whether regulatory action is warranted.

**Discussion**

The issues raised by the "meme" stock trading frenzy earlier this year and the increasing use of digital trading applications are complex and interrelated. As stated in previous comments submitted to Congress, we believe a few issues deserve further scrutiny and have categorized them into two buckets: (1) investor protection and (2) safety and soundness.

**I. Investor Protection.**

A. Customer Protection and the Gamification of Trading**:** A quote in a recent Netflix documentary, *The Social Dilemma,* says "[i]f you're not paying for the product, then you *are* the product!"[3] In this case, the product is the customer's trade, and the business model is centered around generating as many customer trades as possible and then selling those trades to a third party for profit. So, while customers are told they can trade for 'free', the reality is a little more complicated.

1. Question 3.6 of the Request asks "Do broker-dealers consider the observable impacts of DEPs when determining if they are making "recommendations" for purposes of Regulation Best Interest (Reg BI)? How does the fact that a DEP might impact the behavior of a statistically significant number of retail investors affect this determination?"

Without a doubt, trading applications have made investing easier and more accessible for the average investor. But it's also fair to examine – as the Request does under Section C and with the above-referenced question - whether some trading apps raise certain investor protection concerns and whether rules such as Reg BI should apply to them. One question we have is whether a trade executed from a "self-directed"[4] account on a trading app can actually be a solicited trade. More

[2] Request at 9

[3] *The Social Dilemma*. Directed by Jeff Orlowski, Argent Pictures, 2020. *NetFlix.*

[4] 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.

specifically, is it a trading recommendation when a firm uses an interactive artificial intelligence algorithm to target the behavioral characteristics of its customers to induce 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?"[5] It is difficult to understand how a digital application that uses predictive analytics designed to influence a customer's behavior to enter into a trade does not trigger the customer protection rules, including Reg BI.

2. The Interactive Digital Application. Question 1.5 of the Request asks: "Are DEPs used to promote or otherwise direct retail investors to specific securities or certain types of securities, investment strategies, or services?...Do firms used DEPs to promote or otherwise direct retail investors to securities, investment strategies that are more lucrative for the firm or that may be riskier to the retail investor than others – such as: margin services, options trading, proprietary products, products for which the firm receives revenue sharing or third-party payments, or other higher fee products?"

We believe these are fundamental questions and get to the core of the problem and the conflicts with the business model of certain digital trading applications.[6]

The use of predictive data analytics to increase the revenue of a digital application must be regulated when that applications' profitability is solely dependent upon frequent trading by its customers.

As noted above, some of these applications targeted at retail investors also 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. Interactive trading apps include these basic functions as well, but they integrate artificial intelligence algorithms to learn about their customers in order to send them targeted alerts about specific stocks based on their previous trading habits or to 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

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[5] https://www.finra.org/rules-guidance/guidance/reports/2021-finras-examination-and-risk-monitoring-program/communications-with-public
[6] https://www.sec.gov/news/public-statement/gensler-amac-2021-09-27?utm_medium=email&utm_source=govdelivery#

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.[7]

The interactive app's use of these game-like features seems to serve no other purpose than to stimulate as much trading by customers as possible while they are logged in.[8] It's not an exaggeration to say that customers are made to feel as if they are being 'sold' certain stocks while using it.

There is growing awareness that the addictions to scrolling and time spent on social media and digital applications can be harmful to the mental health and well-being of users, particularly young people.[9] Creating an environment that caters to such an addiction while simultaneously encouraging users to risk their savings in the stock market is a recipe for trouble.

B. Customer Protection Rules and the Interactive App. As Congressman Jim Himes pointed out earlier this year "[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."[10] We agree, which is why we believe that the popularity of 'free' interactive trading applications should be carefully weighed against the importance of the customer protection rules.

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 regulators should make the following determinations: (1) whether the account really "self-directed'; (2) whether the solicitation, Regulation Best Interest, churning, and other customer protection rules be applied to the algorithm carrying out the "recommendations" under such a model; and (3) whether it is suitable for retail customers with little-to-no trading experience to be offered the ability to leverage their account by trading on margin.

C. Copy Trading and Cryptocurrencies

The Request also briefly raises questions regarding the practice of "copy trading" whereby digital applications incentivize and enable investors to copy the trades of others. This practice has become commonplace in the largely unregulated cryptocurrency market and raises significant investor protection concerns.

[7] 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;
[8] Alter, Adam, Irresistible: The Rise of Addictive Technology and the Business of Keeping Us Hooked, Penguin Books, 2018.
[9] https://www.wsj.com/articles/facebook-knows-instagram-is-toxic-for-teen-girls-company-documents-show-11631620739?mod=article_inline
[10] "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

As the ASA recently stated in a letter to the Senate Banking Committee, the SEC needs to provide regulatory clarity surrounding the growing market and trading of cryptocurrencies, including approving applications for exchange-traded funds that hold physical cryptocurrencies.

Over the last few years, the combination of new technologies and the "gamification" of trading has led to an explosion of interest and speculative trading in cryptocurrencies. Many young investors – who have never experienced adulthood without a smartphone and apps that provide instant gratification in their hands – increasingly day trade cryptocurrencies on any number of unregulated trading platforms, many of which lack transparency into fees and spreads.[11]

This has led to a kind of "Wild West" when it comes to crypto and presents significant risks for new and inexperienced investors who have not gone through a sustained market and economic downturn that depresses asset prices over a long period of time.

Regulators – including the SEC – have taken a confusing approach to regulating cryptocurrencies and crypto platforms. Instead of providing public statements or interviews that hint at what the SEC may or may not do in the future when it comes to crypto, we believe the SEC must take bold and comprehensive action to establish rules of the road and protect investors. Like commodity ETFS, this will help the crypto market evolve and give the SEC a regulatory hook into crypto trading platforms alongside the CFTC.

This should include approving applications for ETFs that hold cryptocurrencies, and explaining to the public how cryptocurrencies can be displayed in customer accounts and be traded on the same platform alongside regulated markets.

Most important, the SEC's approval of funds that hold physical cryptocurrency would help capital flow into investment products that are regulated and transparent. Providing clear rules would also assist registered brokers and investment advisors in navigating this new world to ensure their clients have access to alternative products but are not exposed to potentially harmful risks including unfair pricing.

We also believe clarity is necessary to avoid the type of systemic risk that can accompany unrelated crypto trading platforms that offer 50-to-1 and 100-to-1 leverage. To be clear, a drop in the price of a crypto asset that is leveraged to that degree could have spill over effects into the equity, fixed income, and commodity markets as forced margin selling takes place. It is this scenario, that Chairman Gensler warned about when he said that the interplay among "data, model design, regulatory, algorithmic coordination, and user interface … may heighten systemic risk".[12]

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[11] https://www.americansecurities.org/post/asa-sends-letter-to-senate-banking-on-sec-oversight-hearing

[12] "Deep Learning and Financial Stability", Gary Gensler and Lily Bailey, Working Paper as of November 1, 2020, https://ssrn.com/abstract=3723132

**II. 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 in early 2021, 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.

B. Regulation SHO & Stock Lending. We believe the growing attention to "meme" stocks, and the gamification of trading also create an impetus for the SEC to examine and address longstanding issues related to short sales which became apparent in early 2021.

Our basic question is how can a company's stock have a short position of 140% of the shares outstanding? Professor James Angel simply describes it like this "the same shares can be lent over and over again."[13]

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.[14] This is how retirees, pensioners, working families, and mom-and-pop investors who didn't know they owned GME were impacted during the mania.

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[13] 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".

[14] 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."

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 the SEC should thoroughly examine the details of the Reg SHO delivery rules[15] and the mechanics and pricing of stock lending arrangements.

A thorough examination by the SEC 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.

## III. <u>Conclusion</u>.

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 promote the public's confidence in them. The ASA looks forward to being a resource as the SEC works through these issues and considers new regulations.

Sincerely,

Christopher A. Iacovella

Christopher A. Iacovella
Chief Executive Officer
American Securities Association

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