UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE CHAIR

February 25, 2021

The Honorable Elizabeth Warren
United States Senate
309 Hart Senate Office Building
Washington, DC 20510

Dear Senator Warren:

Thank you for your January 29, 2021 letter regarding the recent volatility in the market, particularly with regard to shares of GameStop Corp. (GME). I appreciate your input and the thoughtful questions you have raised on these important and evolving issues. I remain focused on the functioning of our markets and particularly on any potential negative impacts these events may have on investors and market confidence. The staff has and will continue to consider all the issues you raise as they conduct a study of these events.

The Commission remains fully committed to its mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. This work includes closely monitoring and evaluating the recent volatility, consulting with our regulatory partners, and reviewing actions by market participants and others in order to protect investors and to identify and vigorously pursue any potential wrongdoing. Additionally, I am committed to working with staff and my colleagues to conduct a timely study of these market events and the myriad of issues implicated by them, including those you raised.[1]

These events and associated impacts are still being analyzed. Based on this analysis, the Commission will consider what regulatory actions may be appropriate. In response to your letter's questions, I briefly discuss below our current understanding of the recent market volatility and its impact on the financial system, and regulatory actions we are taking in response to recent market volatility, including the enforcement of Commission rules designed to support market infrastructure operations and to promote resiliency. I further discuss fraud and market

[1] Treasury Secretary Yellen recently announced that, while the core market infrastructure was resilient during high volatility and heavy trading volumes, the top financial regulators "agree on the importance of the SEC releasing a timely study of the event." Prior staff studies following market events – such as following the 2010 flash crash and the 2014 Treasury market volatility – facilitated discussion and evaluation of appropriate policy considerations. *See Findings Regarding the Market Events of May 6, 2010*, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (Sept. 30, 2010), *available at* https://www.sec.gov/files/marketevents-report.pdf; *Joint Staff Report: The U.S. Treasury Market on October 15, 2014* (July 13, 2015), *available at* https://www.sec.gov/files/treasury-market-volatility-10-14-2014-joint-report.pdf.

manipulation and highlight some of the Commission staff's actions to date in response to the recent volatility.

Market Volatility and Systemic Impact

In response to your first question, the Commission staff is diligently examining the causes of the recent dramatic shifts in GameStop share prices, including the impact of the short positions of large investors such as hedge funds, the role that social media such as online message boards may have played, as well as trading restrictions imposed by certain broker-dealers, and whether these practices violated existing securities laws.[2] Once we have a better understanding of the facts, we will be in a better position to assess whether the changes in GameStop share prices are consistent with a "fair, orderly, and efficient" market function.[3] As discussed in more detail below, it would be premature to comment on whether or not any specific individual or entity's conduct violated existing law.

Regarding your second question, we share your concern that "wild swings in value of GameStop and other companies affected by similar trading schemes" may present "systemic concerns for financial systems or the stock market."[4] As we learned from the 2008 financial crisis and Congress's legislative response, it is important that regulators remain on guard against systemic risks to our financial system, and the Commission appreciates your consistent dedication to ensuring that the SEC is doing so. That said, it does appear that our core market infrastructure has proven resilient during the recent events, as my colleagues and I have noted.[5] To date, the Commission staff are not aware of any structural issues resulting from recent significant volatility in the price of certain stocks that indicate a disruption of core market infrastructure. Additionally, the Commission staff regularly monitors the functioning of market infrastructure with an eye toward identifying structural issues that may interfere with fair and orderly markets. Nevertheless, I will be instructing the staff in the ongoing study to take a focused look at the possibility that such trading events could pose systemic risks in the future. I welcome the opportunity to engage with you and your staff on this subject going forward.

In response to your question about "what steps … the SEC [will] take to ensure that securities markets better reflect prices that are in line with the intrinsic and fundamental value of underlying companies,"[6] I share your concerns about stock prices that significantly deviate from what appears justified by market fundamentals, and the Commission is considering this carefully in its study. At all times, but especially in times of market turbulence, it is imperative that

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[2] *See* NPR, *SEC Acting Chair Unpacks the GameStop, Reddit, Robinhood, Wall Street Debacle* (Feb. 1, 2021, 4:28pm), *available at* https://www.npr.org/2021/02/01/962946809/sec-acting-chair-unpacks-the-gamestop-reddit-robinhood-wall-street-debacle.

[3] Letter from Sen. Elizabeth Warren to Allison Herren Lee, Acting Chair, Commission 4 (Jan. 29, 2021), *available at* https://www.warren.senate.gov/imo/media/doc/01.29.2021%20Letter%20from%20Senator%20Warren%20to%20Acting%20Chair%20Lee.pdf.

[4] Letter from Sen. Elizabeth Warren to Allison Herren Lee, *supra* note 3, at 4.

[5] *Statement of Acting Chair Lee and Commissioners Peirce, Roisman, and Crenshaw Regarding Recent Market Volatility* (Jan. 29, 2021), *available at* https://www.sec.gov/news/public-statement/joint-statement-market-volatility-2021-01-29.

[6] Letter from Sen. Elizabeth Warren to Allison Herren Lee, *supra* note 3, at 4, 5.

markets continue to function and remain fair, orderly, and efficient. As you note, disorderly, inefficient, and unfair securities markets can have a negative impact on investors, communities, consumers, and workers. For example, if a short seller disseminates misleading or false information about a company, this could negatively impact the company and even threaten its viability as an on-going business, thereby harming: (1) investors through a reduction in the stock price; (2) workers who are laid off or see a reduction in the value of their stock holdings in the company; (3) communities through the economic effects of those layoffs; and (4) consumers who may lose access to the company's products or services.[7] Significant volatility in prices of particular equities can ultimately increase the likelihood of investor harm,[8] and, consequently, the Commission staff monitors situations such as these very closely.

The Commission is always concerned with the impact of significant volatility that is not explained by apparent market fundamentals. As you know, the Commission and other governmental authorities and market participants continue to work together to ensure that markets function during times of market volatility. Our regulatory tools have evolved to address the challenges that our markets have confronted in previous stressful events, such as the market volatility in March 2020 and the "flash crash" in May 2010. The Commission also has regulations in place designed to address market infrastructure and to promote resilience. For example, the Commission's Regulation Systems Compliance and Integrity (SCI) strengthens the technology infrastructure of the U.S. securities markets. Specifically, the rules are designed to reduce the occurrence of systems issues, improve resilience when systems problems do occur, and enhance the Commission's oversight and enforcement of securities market technology infrastructure. The Commission staff will examine closely whether these rules and others performed as designed in response to the issues raised by these events in order to identify any gaps that may need to be addressed.

Further, the Commission has always remained focused on whether investors have access to sufficient information to make informed investment decisions. As part of the staff's efforts to protect investors in response to the recent volatility, the Commission's Office of Investor Education and Advocacy recently issued a staff bulletin highlighting the risks associated with volatile markets and short-term trading based on social media.[9] Our Division of Corporation Finance also issued a sample comment letter that highlights disclosure considerations for companies seeking to raise capital in securities offerings amid market and price volatility. This letter includes sample comments regarding disclosure, among other things, about inconsistencies between recent changes in a company's stock price and changes in actual or expected operating performance, financial condition, or other indicators of value.

That said, these tools clearly have not eliminated all extreme volatility from the markets. I believe the Commission should take this opportunity to consider additional changes to our regulations to, among other things, provide better safeguards against prices dramatically departing from fundamental values. Our markets are the best in the world, but we do not rest on

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[7] *See*, *e.g.*, Joshua Mitts, Short and Distort, Columbia Law and Economics Working Paper No. 592 (Feb. 13, 2020), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3198384.

[8] *See* George Sisti, Do the math: Volatility hurts your portfolio, MARKETWATCH (Feb. 26, 2013), *available at* https://www.marketwatch.com/story/do-the-math-volatility-hurts-your-portfolio-2013-02-26.

[9] *Investor Alert: Thinking About Investing in the Latest Hot Stock? Understand the Significant Risks of Short-Term Trading Based on Social Media* (Jan. 29, 2021), *available at* https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-62.

that premise. We must ensure that our regulations and actions keep pace with the challenges of modern markets. Until we have a better understanding of exactly what happened, it is premature to identify fully all the steps that should be taken to fix potential issues. Nevertheless, at this point, I believe we should seriously consider additional regulations in a few areas. Specifically, I believe the Commission should consider crafting regulations that require firms providing options trading to retail customers to disclose more information to those customers and more closely examine whether retail customers understand such products. It is critical that firms conduct sufficient due diligence about whether individual customers qualify to trade options and other complex products before those customers begin trading such products. Additionally, I believe the Commission should consider requiring increased disclosure of short-selling to regulators and the general public as well as completion of the Dodd-Frank mandate for a rule under Section 929X of Dodd-Frank.[10] Finally, I believe the Commission should examine the effects of certain firms receiving payment for access to their order flow to determine, among other things, whether these practices are properly and thoroughly disclosed and fully consistent with best execution obligations. As noted above, however, we are continuing to analyze the recent market events, and the outcome of that review may ultimately lead us toward different or additional policy considerations.

Fraud and Market Manipulation

With respect to your fourth question regarding market manipulation, the Commission takes market manipulation seriously and has a long history of investigating and prosecuting those who seek to fraudulently manipulate stock prices and interfere with the free and fair operation of the market. While I am unable to discuss the existence or nature of any specific investigation regarding recent market events or provide a detailed timeline regarding steps we are taking to update and implement rules defining market manipulation, I can assure you that in the course of our review of the events, we are evaluating whether the SEC's current regulatory regime is sufficient to address potential misconduct that may have occurred in connection with the recent market volatility. To the extent it is helpful for now, I provide below a brief overview of regulations designed to prevent market manipulation.

As you know, the federal securities laws and regulations broadly prohibit fraud in the offer, purchase, or sale of securities, including activity designed to fraudulently manipulate a stock's price. For example, it can be a violation of Section 10(b) of the Securities and Exchange Act of 1934, or Section 17(a) of the Securities Act of 1933, to disseminate false or misleading information about a security in an effort to artificially pump up its price and profit therefrom. Similarly, Section 9(a) of the Exchange Act makes it illegal to engage in trading that is designed to artificially increase or decrease the price of a security for the purpose of inducing others to buy or sell the stock. These are only some examples of ways in which individuals or entities may engage in market manipulation in violation of the federal securities laws. To the extent that our review of the facts in this situation reveals regulatory gaps in the SEC's enforcement regime, we would welcome a conversation regarding potential action to fill those gaps.

It should be noted, however, that some of the activities associated with recent market events may not squarely fall within our current authority to prevent and police market

[10] See Dodd-Frank Act Section 929X(a) (codified as amended at 15 U.S.C. § 78m(f)(2) (2012)).

manipulation. Much of our enforcement authority regarding market manipulation revolves around the concept of "deceit;" in other words, conduct with an intent to knowingly mislead or misrepresent a person's interests or holdings. If a person or persons involved in causing a major market event could not be shown to have engaged in knowing or reckless deceit, there could be uncertainty regarding the success of an action brought for market manipulation. We continue to analyze and consider this issue carefully.

In addition, the Commission's examination and enforcement efforts to address conduct that violates the federal securities laws also promote market integrity. Timely identification of misconduct that harms investors and undermines confidence in our markets is critical, and the Commission's examination and enforcement staff routinely inspect and investigate potential non-compliance with applicable regulatory obligations.

In particular, the Division of Examinations is currently conducting examinations to review actions taken by various regulated entities (including broker-dealers and clearing agencies) related to the recent volatility to, among other things, promote compliance with the federal securities laws. Coordinating with divisions and offices across the Commission, our Division of Enforcement proactively surveils the market for possible violations of the federal securities laws, including misconduct involving fraud, manipulation, and misrepresentations in disclosures to the customers of broker-dealers. When Commission staff identify possible instances of such violations, they work to halt the misconduct and prevent or minimize investor harm.

As a matter of policy, the Commission conducts investigations on a confidential basis and generally does not acknowledge the existence or non-existence of any investigation unless or until charges are filed. This is to protect the integrity of our investigations, safeguard the privacy of witnesses, and avoid damaging the reputation of persons who may not be charged. Accordingly, as noted above, I cannot comment specifically on whether any particular matters raised in your letter are currently under investigation, but I assure you that the Commission staff is considering carefully the information included in your correspondence in connection with our statutory and regulatory responsibilities.

I would also note that data collected by the Consolidated Audit Trail (CAT) is intended, in part, to assist Commission staff in investigations of potentially manipulative trading. Broker-dealers are now reporting core transactional data for equities and simple electronic options to the CAT. This data assists in understanding trading activities and in conducting investigations, but will be most useful when all data elements are reported and complete. Pursuant to amendments adopted by the Commission on May 15, 2020, an implementation plan and quarterly progress reports are now published on the CAT NMS Plan website (catnmsplan.com). The implementation timeline provided on the website for the CAT NMS Plan indicates that implementation should be completed in 2022.

While we would welcome additional resources given the size and complexity of our markets and the ongoing and evolving risk of fraud and market manipulation, we are working to identify and address possible violations of the existing federal securities laws. The Commission staff are also considering the effectiveness of existing regulations to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation, and will make recommendations for potential action to address any issues or gaps identified.

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Thank you again for your letter and your continued, thoughtful focus on our mission. Please do not hesitate to contact me at (202) 551-2100, or have a member of your staff contact Justin Slaughter, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010 if you have any additional concerns or comments.

Sincerely,

Allison Herren Lee
Acting Chair