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Q&A- U.S. SEC unlikely to ban payment for order flows, but could force more disclosure from financial firms: Ian Katz, Capital Alpha



The recent retail trading frenzy with “meme” stocks like GameStop will be a top priority for the U.S. Securities and Exchange Commission (SEC), but the regulator is most likely to tackle the issue by increasing disclosure requirements for financial firms and brokerages, **Ian Katz, managing director at research firm Capital Alpha Partners** told the Reuters Global Markets Forum on March 3, 2020.

“I doubt that the SEC would actually ban payment for order flow, for example… they will force firms to disclose more, and more prominently, about their payment for order flow relationships,” Katz said.

He added that under Gary Gensler, President Joe Biden’s pick to lead the regulator, a bitcoin ETF is much more likely to be approved, but the SEC will firmly use enforcement mechanisms against any errant cryptocurrency firms to send a clear message to others.

Following are edited excerpts from the conversation:

Q: What were your thoughts on Gary Gensler's hearing yesterday, and what glimpses did we get into what his priorities as SEC chair might be?

A: I was actually expecting a bit tougher questioning of him. But I think he made it clear that he wants to look into all the issues surrounding the GameStop/Robinhood episode without committing to what exactly he'll do. Clearly it will be a top priority when he starts, to gather facts on what happened and get the opinions of SEC staff on where they can go from here.

He made it clear that he wants to look into payment for order flow arrangements and the "gamification" of app trading. He referred to confetti and balloons on the apps. So it's pretty clear he's not a fan of those kinds of bells and whistles.

Q: On that note, we've already had multiple hearings on the recent retail trading/short squeeze frenzies last month. Do platforms like Robinhood have much to be worried about in terms of new regulations?

A: I think they need to be aware that there may be increased regulation, but I think it will come mainly in the form of increased disclosure requirements. I doubt that the SEC would actually ban payment for order flow, for example. However, one thing that could really impact brokerages down the road is if the SEC decides that capital requirements, like the net capital rule, need to be beefed up and require brokers to hold more capital. That would take a while to happen, but you can't rule it out.

Q: The SEC said it would review how companies are disclosing the risks they face from climate change. Is it likely the SEC will introduce their own rules, or perhaps just mandate the recommendations from the Task Force on Climate-related Financial Disclosures?

A: I think the SEC will take those recommendations under consideration, but at the end of the day they will make their own decision. Of course, Gensler will consult with staff, and there will be input from the Republican commissioners on the SEC commission.

Q: Any expectations on timelines?

A: That's a tough one. I would expect that they will start making some kind of proposal on disclosures this year, but we probably wouldn't see anything finalized till next year. And that could slip. The rulemaking process is time-consuming and almost never goes as quickly as they would hope.

One thing we really didn't get from the hearing yesterday was a sense of what Gensler will tackle first, then later. I suspect he will have to go after the market stuff, like GameStop first.

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Q: Do you think there'll be much pushback against some of the changes Gensler would pursue from the Republican commissioners?

A: Absolutely he will get pushback from the Republicans. I think he will have a civil enough relationship with them. He mentioned that in the hearing yesterday, that he knows both of the Republican commissioners. But I don't think Gensler will waste much time or energy trying to get consensus that isn't going to come. I don't think he'll be concerned about having a 3-2 vote.

Some SEC chairs historically have tried to get the other side to come aboard. But usually it doesn't work out and they end up just wasting time trying to get consensus.

Q: You mentioned the SEC's unlikely to ban payment for order flow, but are these practices going to face higher scrutiny going forward?

A: I think so. At the end of the day, the SEC is very much a disclosure agency. So I think they will force firms to disclose more, and more prominently, about their payment for order flow relationships.

Q: Given bitcoin's run over the past few months and signs of increased adoption, what sort of new measures might regulators adopt?

A: That's an interesting one. Gensler is a fan of crypto, at least philosophically. He taught a Blockchain class at MIT. However, he made it clear that he isn't going to let crypto firms get away with any shenanigans.

The Democrats under Biden are making a point of emphasizing their commitment to defend consumers and investors, and the little guy more broadly. Just because Gensler likes crypto doesn't mean he will go soft on them enforcement-wise. So I think that if the enforcement division has the opportunity to smack a crypto firm that clearly defrauded customers, it might take the opportunity to make an statement with a big fine or penalty.

And furthermore more broadly, Gensler said enforcement can be used against little firms to send a message. That didn't get much attention yesterday, but I thought it was significant.

Q: The last SEC chair commented that bitcoin is not a security - do you think Gensler has a different view?

A: I'm not sure, but I will say that on the question of a Bitcoin ETF, it's more likely under Gensler than it was before… I think it went from almost no chance to almost 50-50.

Q: The financial transaction tax (FTT) is another proposal that's gathered buzz lately, what chances do you see of this moving forward?

A: On the FTT, I'm sceptical. Here's why: You probably can't get any Republicans on board for that and so you would need every Democrat, and I think there are several moderate Dems who wouldn't support it. I think for that to happen there would need to be another bad scandal involving a big bank or Wall Street firm. Like if you had another Wells Fargo, then yeah, there would be a populist outcry and all bets are off. But right now, no, I don't think there's support in Congress for it.

But it will be a topic of discussion later when the Dems try to raise taxes or get an infrastructure bill. It will be seen as a pay-for potentially. So there will be a lot of talk about it. And, and we like to say, headline risk for investors. But I don't think it ends up going through, based on what we know now.

Q: You cover asset management, what are the big trends in this sector for the rest of 2021?

A: A big topic is Regulation Best Interest. Surprisingly, Gensler didn't get a single question about that yesterday**.** But I think the SEC will change that in some way. They may start with guidance, allowing them to beef up enforcement on it. And the Department of Labor (DOL) will also probably try to revise the fiduciary standard. Those things will take time. But I don't think Gensler goes the next two years without tackling Regulation Best Interest.

I think the Democrats really want to fix the conflict of interest aspects of it. They don't think that disclosing a conflict is enough. They want to eliminate the conflicts. Not clear how far they will go, but that will be the intention.

Q: What would be the biggest change to the sell side from Regulation Best Interest?

A: I think whenever the SEC and DOL go into this, it can be an issue for folks selling annuities.

Q: It's more for retail brokers / advisors? Any impact on wholesale markets?

A: Yes, I'm inclined to think it's more there.

Q: Any parting thoughts for us?

A: [Kind of] big picture: I think when Biden took office there was some relief in markets that he seemed to go pretty moderate in his first appointments, including Yellen at Treasury. Since then, they have been more progressive -- Gensler, Chopra, even Michael Barr for Office of the Comptroller of the Currency if he goes through. So the regulators are turning out to be pretty progressive. And I don't think they will be shy about pursuing their agenda.

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