INVESTMENT COMPANY INSTITUTE

MEMO# 33864

October 26, 2021

Summary of SEC Staff GameStop Report

[33864]

October 26, 2021

TO: Equity Markets Advisory Committee
Securities Operations Advisory Committee RE: Summary of SEC Staff GameStop Report

On September 26, SEC staff issued a report examining the January 2021 trading activity in GameStop stock (GME), which has led regulators and other policymakers to focus on certain equity market structure issues. While the report does not address the underlying causes of the "meme stock" phenomenon, it provides evidence that contradicts some views about the cause of increased GME trading, such as the belief that the activity was driven by a short squeeze on short sellers buying to cover their positions. Below is a summary of the report, including highlights of the equity market structure issues that SEC staff recommends should be further examined.

Trading Conditions in GME

The report describes the increased trading activity and resulting price swings in GME in early 2021, but also notes that the stock had already exhibited volatility during 2020.[1] From its intraday low on January 8 to intraday high of $483 on January 28, GME's intraday share price increased approximately 2,700%, followed by a decrease to the closing price of over 86% by early February. The report further highlights that from January 13 to January 29, an average of 100 million GME shares traded daily, representing an increase of over 1,400% from the 2020 average. During this time, market participants experienced multiple volatility-induced trading disruptions and deteriorations in liquidity.[2] The increases coincided with a large increase in the number of individual accounts actively trading GME—from less than 10,000 accounts in early January to nearly 900,000 accounts by January 27. The report, however, contends that GME's share price and volume swings were not unusual relative to other meme stocks during January 2021.[3]

The report also confirms that GME options trading increased significantly during that month. Compared to the fourth quarter of 2020, where they traded at an elevated median of 84,000 contracts per day at a median dollar value of $10.5 million (with a maximum of 560,000 in one day), over 2 million contracts traded at a value of over $8 billion on January 27. This increased activity concentrated heavily in short-dated call options. Individual customer accounts at three retail brokers comprised a higher percentage of this activity and represented 91% of non-market maker options volume in mid-January.

Short Activity in GME

The report highlights the significant short interest and short selling activity in GME during this time, although it notes that GME's short interest had hovered around 100% as a percentage of its public float throughout most of 2020. In January 2021, for example, GME was the only stock that SEC staff observed as having short interest of more shares outstanding.

The report acknowledges that the high short interest in GME and associated price volatility suggest a short squeeze had occurred, but SEC staff did not find conclusive evidence that this was the primary explanation for increased trading volumes and price increases.[4] While the data shows that some of GME's sharp price increases coincided with known major short sellers covering their short positions, it also shows that such buying comprised a small fraction of overall buy volume and GME share prices continued to say elevated for an extended period. Therefore, the report concludes that positive sentiment likely sustained GME's price appreciated over time.

The report also notes that while some hedge funds incurred significant losses in closing out positions, others who held long positions in GME benefited from the price appreciation. Overall, hedge funds were not significantly affected by meme stock investments, and SEC staff did not observe registered funds experiencing liquidity issues or difficulties with counterparties.

Role of Off-Exchange Market Makers

The report observed that the distribution of GME trading changed from typical patterns and spread across venues. Specifically, the dollar volume percentage of off-exchange GME executions in late January consistently fell below 50%, reaching a low of 32.83% on January 28. In contrast, approximately half of GME's dollar and share volume in 2020 had been executed on a national exchange versus off exchange. Of the trading that occurred off exchange, 80% of the dollar volume was internalized, with 88% of that amount executed by Citadel Securities, Virtu, and G1 Execution Services.[5]

GME's Impact on ETFs

The report specifies that some ETFs and private funds were affected by the GME trading activity in January 2021, such as large increases in GME's portfolio weight, high redemption levels, and increased bid-ask spreads.[6] While this raised concerns about whether the market price of an impacted ETF's shares might decouple from its NAV, SEC staff did not identify a failure of the creation or redemption process or any other operational challenge beyond observed volatility. They also stated that the large spike in net redemptions—nearly 6 million shares on January 27—may be consistent with shorting activity in XRT, which could have further contributed to the discrepancy between its closing price and NAV.

Other Issues

The report highlights other issues arising from January's GME volatility, such as clearing agency margin and capital issues. On January 27, the National Securities Clearing Corporation (NSCC) and the Options Clearing Corp (OCC) experienced record clearing volumes. Given the heightened volumes and volatile share prices, NSCC made intraday margin calls to 36 clearing members that totaled $6.9 billion. Of this amount, $4.8 billion reflected a special excess capital premium charge imposed on 18 members.

The report also discusses the trading restrictions imposed by some broker-dealers in certain stocks in reaction to margin calls and capital charges imposed by NSCC. It emphasizes that these trading restrictions were not imposed by NSCC, which lacks the ability to instruct its member firms to stop trading or clearing. Further, the report acknowledges the belief held by some that broker-dealers were pressured by hedge funds and their commercial partners to restrict trading, but it highlights other reasons that led broker-dealers to do so, such as increased margin calls from NSCC and/or capacity issues related to available unique order IDs.

Recommendations

The report ultimately does not endorse specific policy recommendations, but it suggests relevant areas for additional potential study:

- Forces that may cause a broker to restrict trading: The report suggests mitigating systemic risk from thinly capitalized broker dealers who may not be able to meet increased margin calls by shortening the settlement cycle.
- Digital engagement practices and payment for order flow: The report notes that payment for order flow may incentivize broker-dealers to find ways to increase customer trading, such as through digital engagement.
- Trading in dark pools and through wholesalers: The report notes that wholesalers may be subject to fewer requirements concerning their operational transparency and resiliency compared to exchanges or ATSs.
- Short selling and market dynamics: The report suggests that improved reporting of short sales would allow regulators to better track the dynamics of short selling and its effect on price dynamics.

Nhan Nguyen
Assistant General Counsel, Securities Regulation

endnotes

[1] For example, the report notes that GME's closing price went from the bottom 10th percentile to approximately the median over the course of 2020 and had closed up nearly 24% with an increase of 34 million additional shares traded (from 4 million the day prior) in late August 2020 after the disclosure of Chewy co-founder Ryan Cohen's investment in GME.

[2] The report notes that (i) on January 28, the daily average relative effective spread for GME was 0.54%, nearly three times the average of the prior year; (ii) the size of the best priced quotes in GME decreased as GME's share price increased, although the notional value of the inside depth remained stable; and (iii) LULD trading pauses were triggered on six trading days in January 2021.

[3] The report notes that the single-day price changes between January 26 to January 27 for certain stocks (KOSS, AMC, NAKD, and EXPR) exceeded any single-day GME price change.

[4] The report acknowledges that a "gamma squeeze"—in which market makers purchase a stock to hedge the risk associated with writing call options on that stock—may also explain

GME's price appreciation. However, SEC staff did not find corroborating evidence, such as a large influx of call option purchases over that time.

[5] The report highlights some of the dollar amounts internalized by certain wholesalers. For example, on January 27, Citadel internalized $4.2 billion of GME; the prior day, while Virtu internalized $2.2 billion of GME on the prior day.

[6] The report notes, for example, that the SPDR S&P Retail ETF (XRT) saw its GME position increase from 1.5% of its portfolio to 19.98% in the month of January, with net redemptions 76.3% of its net assets ($506 million) on January 27. Most of this redemption activity was attributable to ETF market making firms. For a three-day period ending on January 28, XRT traded at a bid-ask spread of $0.073, which was higher than the 52-week average bid-ask spread of $0.011. The data also showed that XRT's closing price exhibited a premium of 1.25% to NAV on January 28, which was larger than historical norms.
