



## Financial Markets Law Committee (“FMLC”)

### Asset Management Scoping Forum

Date: Thursday 25 February 2021

Time: 2.00pm to 3.30pm

Virtual meeting

#### Attendees:

Ezra Zahabi (Moderator)

Phil Bartram

David Gasperow

Jonathan Gilmour

Michelle Kirschner

Ida Levine

Philippa List

Jon May

Selina Sagayam

Akin Gump Strauss Hauer & Feld

Travers Smith LLP

Orbis Investment Advisory Limited

Travers Smith LLP

Gibson, Dunn & Crutcher UK LLP

Impact Investing Institute

Dechert LLP

Marshall Wace LLP

Gibson, Dunn & Crutcher UK LLP

Chhavi Sinha

Katja Trela-Larsen

FMLC Secretariat

FMLC Secretariat

#### Guest Speakers

Brandon Hammer

Marc Rotter

Cleary Gottlieb Steen & Hamilton LLP

Cleary Gottlieb Steen & Hamilton LLP

**Registered Charity Number: 1164902.**

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## **Minutes:**

### **1. Introductions**

- 1.1. Ms Zahabi opened the meeting.

### **2. FMLC Scoping Forums (Katja Trela-Larsen)**

- 2.1. Ms Trela-Larsen explained that the FMLC’s remit covers the entirety of the wholesale financial markets. In order to identify issues of legal uncertainty, the FMLC Secretariat runs ten Scoping Forums, each focused on a specific area of the financial services. Ms Trela-Larsen reminded members how Scoping Forums work in practice to further the aims of the FMLC, their role in Forum and the Forum’s conduct of business rules.

### **3. GameStop/Robinhood: U.S. Regulatory Implications of the Recent Volatility for Market Participants (Brandon Hammer and Marc Rotter)**

- 3.1 Mr Rotter provided an account of the recent events related to the trading in the shares of GameStop, whose stock prices surged from a low of less than \$20 in early January to a high of nearly \$500 on 28 January—an increase of well over 1,000%—for no discernible reason beyond the efforts of internet message board users to force a “short squeeze” targeting asset managers who shorted GameStop’s stock. The trading frenzy in the shares of GameStop, and select other heavily shorted stocks, induced by the trading activities of retail investors on a Reddit subforum, and the consequent action by Robinhood and other popular retail brokers to restrict trading in these stocks has raised many questions around the unlawful manipulation of the market as well as the efficacy of regulatory and risk disclosure obligations imposed on brokers. Mr Rotter explained that the ramifications of these events have been widespread, including the impact on issuers and insiders, potential enforcement action and the role of market intermediaries.
- 3.2 With respect to the impact on issuers, Mr Rotter noted that, as markets are liberalized (as retail investors are able readily to access equities markets and coordinate efforts therein to create massive volatility), issuers should be aware of their strategic options should they be targeted by a similar campaign. He noted that, in the U.S., the Securities Exchange Act of 1934 or the “SEA” imposes liability on the issuer for a significant drop in a share price for which no reasonable explanation could be provided or no proper disclosure could be made. The issuer might consider addressing any potential harm by monitoring and becoming aware of the situation before it gets out of control. Mr Rotter added that an issuer might be faced with the question of when and how to make a public offer or what information to disclose.

He noted that the Securities and Exchange Commission, (“SEC”) has issued guidance covering the event an issuer wishes to make a primary offer during times of extreme price volatility, whereby disclosures regarding market volatility, risk factors and share squeeze must be made.<sup>1</sup> Issuer companies have demonstrated hesitance in participating in such a situation, however, because ascertaining trading/market volatility could be difficult from a legal disclosure perspective. Even when the issuer companies decide to make a public offer, the SEC has the power to review the prospectus/registration statement. More recently, the SEC has denied a company from making an offering where a significant increase in the share price of the company was found and the content of the disclosures made in the registration statement was not found satisfactory. Mr Rotter noted that usually the SEC has the power to ensure that proper disclosures are made but does not comment on the content of the disclosures; recently, however, the SEC has gone beyond its power which reflects regulator’s activism in the changing scenario.

3.3 Next, Mr Rotter noted that directors holding 10% of shares in the company are considered insiders in relation to securities trading. While insiders do not need to file a registration statement for selling their shares, they are required to file information about the purchase and sale of their shares. He remarked that not many traders who may be insiders are seen to be filing this information which has raised many questions about their liability for non-reporting.

3.4 Moving on to the potential enforcement actions by the SEC, Mr Rotter explained that it is not clear what actions the SEC will take at this stage, but there is substantial pressure on the regulator to act. He noted that the SEC could consider enforcement actions for two strategies—a) the active trading strategy; and b) the pump and dump scheme. Within active trading, there are several general strategies that can be employed to manipulate the listed stock. Day trading, position trading, swing trading, and scalping are four popular active trading methodologies. Pump-and-dump schemes were traditionally done through cold calling but with the advent of the internet, this illegal practice has become even more prevalent. Fraudsters post messages online enticing investors to buy a stock quickly, with claims to have inside information that a development will lead to an upswing in the share's price. Once buyers jump in, the perpetrators sell their shares, causing the price to drop dramatically. New investors then lose their money. The same scheme can be perpetrated by anyone with access to an online trading account and the ability to convince other investors to buy a stock supposedly ready to take off. The schemer can get the action going by buying

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<sup>1</sup> SEC, *Guidance: Sample Letter to Companies Regarding Securities Offerings During Times of Extreme Price Volatility* (February 2021); available at <https://www.sec.gov/corpfin/sample-letter-securities-offerings-during-extreme-price-volatility>

heavily into a stock that trades on low volume, which usually pumps up the price. The price action induces other investors to buy heavily, pumping the share price even higher. At any point when the perpetrator feels the buying pressure is ready to fall off, he can dump his shares for a big profit. Mr Rotter noted that it is not easy to establish charges of pump-and-dump as it is difficult to establish who would be held liable. He explained that, consequently, the SEC is very unlikely to take action against the retail investors active on Reddit. He added that Section 9A of the SEA prohibits the buying and selling of securities for the purpose of creating a false or misleading appearance of active trading in any security, but it is difficult to establish liability under this provision too. Mr Rotter further explained the steps that the SEC might consider taking and the contours of its investigation. He noted that it will be interesting to monitor the steps/actions that SEC will finally take.

3.5 Mr Hammer turned to the role of intermediaries in the clearing system. He explained that there are practices and regulations that govern the activities of the securities intermediaries. For example, in a waterfall practice, where a broker, like Robinhood, agrees with the other broker to buy stock against a fee, resulting in market making by buying and selling of shares. This is done by virtue of fees they charge customers to execute trades. The desire of the retail broker to provide fees is permissible if disclosed to customer and provided that the information on which trade was done is freely available in the market. Mr Hammer explained that allegations of disclosure failures were made against Robinhood. Allegations of making price improvements without any explanations and influencing payment for order flow—where Robinhood would rout the trading order of market participant to each of the retail investors—were also made against Robinhood. Questions were raised as to why Robinhood stopped executing orders with clearing providers. Mr Hammer added that the SEC might consider providing guidance on the margin methodology disclosure and increasing liquidity requirement for the brokerage.

3.6 Members discussed the impact of GameStop manipulation on the U.K. market. They noted that increased participation by the retail investors in the financial market should become a priority for regulators. It will be important to see how existing rules on market manipulation, financial promotions, liquidity requirements and operational resilience will apply to amateur retail investors. Another member added that the GameStop events demonstrate the role of social media in bringing together retail investors to influence share prices. Mr Rotter remarked that it is difficult to see how the SEC will take action against retail investors. A member asked if there was pressure on the SEC from the industry to act and whether hedge funds have expressed their concerns. Mr Hammer explained that there might be litigation against Robinhood, but it is difficult to foresee the outcome. He explained that the SEC is

being pressured to examine the cause of short-selling and to investigate the increase in collaboration between market maker and retail investors.

3.7 Members agreed to monitor regulatory developments in the U.S.

#### 4. Sustainable Finance Disclosure Regulation (Ezra Zahabi)

4.1. Ms Zahabi presented an overview of Regulation (EU) 2019/2088 on sustainability-related disclosures in the financial services sector (the “**SFDR**”) and its application to alternative investment fund managers (“**AIFMs**”); investment firms, Third Country and sub-threshold firms. She explained that a letter dated 7 January 2021 had been sent from the Joint Committee of the European Supervisory Authorities (the “**ESAs**”) to the European Commission regarding the issues relating to the application of the SFDR (hereinafter referred to as the “**ESA letter**”).<sup>2</sup> There remains a lot of uncertainty around the application of the SFDR. Ms Zahabi suggested that it might be useful to discuss the priority questions identified by the Joint Committee of the ESAs which would benefit from urgent clarification to facilitate an orderly application of the SFDR from 10 March 2021.

4.2. Ms Zahabi remarked that the SFDR applies to financial market participants which includes AIFMs. In this regard, no explicit geographic restriction or provision regarding extraterritorial application is provided in the SFDR. She noted that the application of SFDR to U.K., U.S. and other Third Country AIFMs is unclear. In relation to the application of SFDR disclosure requirements to investment firms providing portfolio management, investment advisory services, segregated portfolios, or other types of tailored financial products managed in accordance with mandates given by clients on a discretionary client-by-client basis, she noted that there have been questions regarding the extraterritorial application to non-E.U. investment firms.

4.3. Ms Zahabi brought members’ attention to Article 8 of SFDR which imposes additional transparency requirements on the manager where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics. The ESA letter seeks to clarify when a manager is required to comply with Article 8 with respect to an investment fund. She drew attention to questions relating to whether a financial product which is marketed as taking into account a sustainability factor or sustainability risk in the investment decision will be subject to Article 8 and, if so, how this will be reconciled with the disclosures under Article 6(1) or Article 7(1) SFDR.

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<sup>2</sup> Joint Committee of the European Supervisory Authorities, *Letter to European Commission* (7 January 2021); available at: [https://www.esma.europa.eu/sites/default/files/library/jc\\_2021\\_02\\_letter\\_to\\_eu\\_commission\\_on\\_priority\\_issues\\_relating\\_to\\_sfdr\\_application.pdf](https://www.esma.europa.eu/sites/default/files/library/jc_2021_02_letter_to_eu_commission_on_priority_issues_relating_to_sfdr_application.pdf)

Similarly, it is unclear whether, in the absence of any active promotion or advertising of an environmental or social characteristic, an unadvertised, intrinsic characteristic of the fund, such as a sectoral exclusion (e.g. tobacco) would also qualify as promotion.

4.4. Ms Zahabi discussed several questions raised in the ESA Letter relating to the applicability of Article 9 under the SFDR, including the scope of Article 9 and the remit of the E.U. Climate Transition Benchmark. Finally, derogation under Article 4(4) of SFDR was also discussed. Ms Zahabi added that a lot of uncertainty arises because there is no guidance available on the SFDR, despite the rapidly approaching implementation date of 10 March 2021. She noted that there will be revisions to the current manager's regime.

4.5. A member remarked that the European Commission might soon publish guidelines on issues relating to scope, its position on Regulatory Technical Standards ("**RTS**"), and the taxonomy package, but another member noted that any guidance would now be too late to offer clarity. There also remains the risk that the recitals of the RTS could give rise to further uncertainty without adequate time to request clarification. Ms Zahabi added that it will be important to monitor the SEC's decision on ESG related matters because there could be discussion amongst regulators behind the scenes on non-E.U. and the U.S. groups. Members agreed that the establishment of an international forum to ensure consistency on disclosure requirements for issuers would be useful.

## 5. **Any other business**

5.1. Attendees discussed ESMA's Statement on episodes of very high volatility in trading of certain stocks.<sup>3</sup> Members agreed that ESMA's Statement provides clarity on those provisions of Regulation (EU) No 596/2014 on market abuse ("**Market Abuse Regulation**" or "**MAR**") which relate to market manipulation.

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<sup>3</sup> ESMA, *Statement on episodes of very high volatility in trading of certain stocks* (17 February 2021), available at: [https://www.esma.europa.eu/sites/default/files/library/esma70-155-11809\\_episodes\\_of\\_very\\_high\\_volatility\\_in\\_trading\\_of\\_certain\\_stocks\\_0.pdf](https://www.esma.europa.eu/sites/default/files/library/esma70-155-11809_episodes_of_very_high_volatility_in_trading_of_certain_stocks_0.pdf)