Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street NE
Washington DC 20549-1090

October 1, 2021

Re: File Number S7-10-21

Dear Ms. Countryman:

I appreciate the opportunity to comment on the Securities and Exchange Commission's request for information on the regulation of digital engagement practices (DEPs). I am a law professor who teaches and researches about the regulation of broker-dealers in securities, and enforcement of broker-dealer rules. I also worked for five years from 2015 to 2020 on the staff of the adjudications unit of the SEC's Office of the General Counsel, mostly focusing on broker-dealer and FINRA matters. I joined the faculty of the University of Nebraska College of Law after leaving the OGC staff in August 2020.[1]

My research generally focuses on retail securities markets where investors act like ordinary consumers. In these markets, competition and psychology affect the optimal regulation of services that money managers offer. Firms design contracts so consumers focus on perceived price, underestimating total cost of goods and services. They compete on salient attributes like price, and pair these with nonsalient attributes that are ignored (like costly contract terms, disclosed but opaque conflicts of interest, or long streams of micropayments in the form of inferior trade executions). There are perhaps one or two other securities regulation scholars in the United States studying this issue directly.

My comments highlight my recent scholarship, which bears directly on the SEC's request for information on digital engagement practices. The SEC may find this scholarship relevant to any future rulemaking it undertakes about digital engagement practices. To that end, this comment letter draws mainly on an essay and a working paper I have written in my academic capacity.[2] One article, coauthored with my University of Nebraska College of Law colleague Kyle Langvardt, is forthcoming in the YALE LAW JOURNAL FORUM. A draft version of that article is available online, and I will refer to it here by the shorthand "*Confetti Regulation*."[3]

A second article, a work in progress tentatively titled "*Gamification and Securities Regulation*," is also posted online; I anticipate that I will submit it for publication

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[1] Current and past institutional affiliations given for identification and potential conflict-disclosure purposes only.
[2] Neither article was written on behalf of any other person (besides, in the one case, my identified coauthor).
[3] *See* Kyle Langvardt & James Fallows Tierney, *On Confetti Regulation: The Wrong Way to Regulate Gamified Investing*, 131 YALE LAW JOURNAL FORUM (forthcoming 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3928268.

shortly, and the final citation will be posted to the SSRN page online.[4] As one colleague noted in commenting on the paper, it thoroughly examines all the major arguments for and against regulating digital engagement practices.

Both pieces of scholarship are attached to this letter for the Staff's convenience. These papers look at the problem of digital engagement practices—and how securities regulation might address it—in detail. I will keep this letter's comments brief, summarizing the attached scholarly papers (which themselves include full elaboration and citations to underlying source material) to simplify my bottom-line comments.

I focus on three themes: how we got here; why digital engagement practices might be a subject of concern for securities law; categories of regulatory responses and interventions that the SEC might consider adopting in any future rulemaking on digital engagement practices.

I. How we got here

To begin with, digital engagement practices are the nearly inevitable consequence of several convergent trends in market structure and regulatory practice. First, securities regulators and scholars have observed a long-term trend of retail investors substituting away from direct holding of corporate equities into institutional assets like mutual funds and ETFs, a trend that former SEC general counsel Brian Cartwright called "deretailization." But recent empirical evidence about the volume of retail equity order flow, for instance, suggests a slowdown if not outright reversal of this trend. Ordinary people are now trading more than ever before, for a variety of reasons—only some of which may be traceable to digital engagement practices.

A related convergent trend is price competition on highly salient brokerage commissions. Many discount brokers have competed the price of equity trading commissions to zero, reducing the most significant transaction costs that historically acted as frictions against excessive trading. Brokers do not provide their services as a charity, of course, and have had to find substitute sources of revenue.

The third convergent trend reflects an increasingly important source of this substitute revenue for certain kinds of broker-dealers. At the risk of oversimplifying increasingly complex market structure issues, it is hard to offer a single national best bid or offer across geographically dispersed trade execution venues in continuous-time markets. Distance limits how quickly price quotations can be updated to reflect events on distant markets. Many trading firms have made significant investments in speed to update stale prices, earning fractions of pennies as compensation for this intermediation service. There are risks with this kind of business model, such as adverse selection. One way of reducing that risk is by ensuring that the order flow you are trading against is noisy, in that it does not have better information about future price. Historically one way of doing that has been to trade against retail order flow.

[4] *See* James Fallows Tierney, *Gamification and Securities Regulation* (manuscript dated Sept. 27, 2021), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3916407.

Other comment letters undoubtedly will focus on payment for order flow and related issues, and I will not belabor the topic here. It should suffice to say that some kinds of digital engagement practice are designed to encourage informationally noisy retail order flow to service the broker-dealer's need for a substitute revenue source. Regulators should pay close attention to broker-dealers' incentive to encourage noisy order flow in this way.

II. Digital engagement practices as a subject of concern for securities law

The request for information reveals wide ranging concerns about the role of digital engagement practices in retail securities markets. I focus on a handful of particularly important implications of these practices for securities law.

First, securities law should account for the fact that retail investors may trade for different reasons. For decades, scholars have been concerned about excessive trading by retail investors. Empirical studies from financial economics have long shown that ordinary people typically lack an informational edge when they trade—and do worse the more they trade. But this does not itself support a conclusion that retail traders are all being "gamified" into trading more. Scholars have identified a number of rational and imperfectly rational reasons why people actively trade despite lacking skill or superior information, such as their risk preferences, aspiration for riches, or desire to consume entertainment.

Digital engagement practices appear to be more relevant to two other reasons why people trade in general (and in particular securities). Financial economists examining trade data from Robinhood users have found evidence that some retail traders decide to trade based on what is salient in their decision set, like the presence of a stock on a leaderboard of stocks most held by other brokerage users. This set of reasons for trading—what might be called "attention-induced noise trading"—should be of particular interest and concern to regulators, because it is the evidence most closely linked to the kinds of harms that justify regulatory intervention in the first place. Given the state of the research, in selecting among interventions regulators should be wary of relying too heavily on empirical evidence about how digital engagement practices change people's behavior outside the context of financial markets.

Second, there is indeed a plausible social welfare justification for prohibiting or sharply restricting digital engagement practices. But as is so often the case in securities law, the nature of the social welfare justification depends on the particular facts and circumstances of the practice at issue. We might loosely think of three major categories of first-party and third-party harms from these practices. One is the possibility of waste or loss. If retail investors do worse the more they trade, then on net practices that promote trading may result in aggregate in a loss of retail traders' wealth (and possibly other sorts of measurable welfare), even after taking into account welfare gains from zero-commission trading. This is not a slam dunk argument against digital engagement practices, because people engage in all sorts of nonproblematic transactions that result in a wealth transfer in exchange for some other good or service.

Some observers have suggested that this welfare loss is particularly objectionable if it results in a distributional transfer from retail traders to broker-dealers or other sophisticated financial firms. Securities law could do a better job in general of responding to concerns about the "distributional" effects of legal rules—who wins and who loses. But the SEC should examine carefully the nature of these distributional claims. For instance, if the claim is that inferior execution quality is a distributional harm, what should we think of the possibility that zero-commission pricing make some investors better off than inferior execution quality makes them offsettingly worse off? Perhaps that should not matter if there are other first-party harms (like waste), or broader third-party harms to market quality.

Second, digital engagement practices potentially implicate implicates broker-dealer regulation's traditional concern for reducing conflicts of interest in the broker-dealer relationship. The classic conflict of interest is that the broker-dealer will put its own interest in remuneration ahead of the client's. To that end, securities law has traditionally prohibited brokers from churning discretionary customer accounts to produce commissions, and from making recommendations for high-commission transactions that are unsuitable for the client's particular circumstances.

To the extent that digital engagement practices are those that encourage trading for its own sake, regulators might analogize to these legacy doctrines. There is an important reason for recognizing these practices as familiar problems, or "old wine in new bottles," beyond reducing the regulatory burdens associated with coming up with new legal rules. As Langvardt and I note in our *Confetti Regulation* essay, framing these practices in terms of legacy doctrines may help insulate them from deregulatory legal challenges. The modern version of these legacy doctrines, I suggest in both attached pieces of scholarship, might be the quantitative suitability component of brokers' duty of care under Regulation Best Interest.

Third, securities regulation has not typically been concerned with retail investors who engage in self-directed excessive trading. To be sure, financial economists have found that retail traders perform worse the more actively they trade. But with limited exceptions—like FINRA's rules about "pattern day traders"—in general securities law does not prohibit or even limit retail investors' ability to trade excessively for speculative reasons. And while there is state-level variation in laws restricting gambling in its own right, securities law generally permits a similar kind of retail-trader activity through trading strategies like in-and-out momentum trading. If securities law does not already have a deep-seated normative policy prohibiting retail investor trading—at least not one anything like the policies against churning and favoring suitability—regulators would be venturing out into uncharted waters in prohibiting or limiting retail investor speculation. This does not mean regulators should not consider those solutions, just that they are not among securities law's canonical policies.

The bottom line is that flashy app design is highly salient but not likely to have a meaningful effect in changing people's propensity to trade. Much more worrisome is an entirely different category of DEP, behavioral prompts or personalized recommendation algorithms—combined with machine learning and data analytics practices that hone these practices' ability to influence client behavior. An app that rains confetti down the screen is not nearly as worrying as one that learns what kinds of prompts are more likely to be effective at encouraging me to place a trade—and then responds by serving more of these prompts to get me to trade more. Existing rules may not be sufficient to respond to this kind of practice, especially if they cannot easily be fit into legal categories like "recommendations." In addition, as securities law specialists have pointed out to me at conferences, there may be difficult line drawing problems between this kind of inducement to consume brokerage—and the more typical and possibly more benign inducements like free coffee that brick and mortar broker-dealers might offer retail clients as a courtesy.

III. Regulatory interventions

The attached essay and article offer a detailed description of various regulatory interventions that the SEC might consider in responding to digital engagement practices. I briefly summarize here.

To begin, several responses are non-starters. Most notably, mandatory disclosure is a favored and common response in securities law, but there are already disclosures about the underlying business practices and it is unclear that any retail clients will consume disclosures about digital engagement practices. In addition, as Langvardt and I argue in *Confetti Regulation*, while simply banning objectionable design features might be an attractively simple solution, it would significant First Amendment litigation risk and would possibly bring unwanted scrutiny to other aspects of the securities laws, which are at their core content-based restrictions on speech.

More promising is to rely on legacy doctrines as a framework for thinking about digital engagement practices. To the extent that these practices encourage a kind of noisy retail order flow, they should be understood to encourage retail clients to "churn" their own accounts. The quantitative suitability component of the duty of care under Regulation Best Interest would prohibit this sort of behavioral churning—encouraging a pattern of transactions that serve the broker's interest in remuneration without a reasonable basis for believing *ex ante* that the pattern is in the retail client's best interest. The crux is whether digital engagement practices are understood as a recommendation. As detailed in the attached *Gamification* article, longstanding pre-Reg BI interpretations of what constitutes a "recommendation" suggest that they can be.

As I point out in the article, there is also a more ambitious solution. Whatever the merits of other arguments for regulating behavioral design, and of other techniques for addressing the risks it presents to investors and markets, a bold and modern securities law would step in to address the market structure problem that creates an incentive for broker-dealers to promote digital engagement practices. For instance, if these practices are a consequence of market structure design that makes it profitable to trade against noisy retail order flow, then the SEC should look seriously at ways of reforming Regulation NMS to address that root issue. It might, for instance, move from continuous time pricing to periodic batch auctions to reduce the incentive to create a pool of noisy retail order flow. This would, of course, "waste" existing investments in speed to cater to the existing market. But that should be no obstacle if this kind of reform can eliminate the demand for inducing noisy retail order flow that drives digital engagement practices in the first place.

Finally, the attached articles do not address a number of other possible regulatory interventions, and I do not mean to rule these out by omission. Some may have theoretical or normative merit—like banning retail reading of corporate equities, crypto, or options and requiring individuals to hold funds or diversified portfolios instead—yet are political and practical nonstarters. Others reflect the possibly unfinished business of the Dodd-Frank Act's ambition to harmonize standards of conduct for BDs and RIAs, as implemented in the BDIA regulatory package in 2019 that included Reg BI.

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The SEC should be applauded for closely examining digital engagement practices, a quickly evolving and important area of concern to industry and regulators alike. Digital engagement practices—and especially subsets of particular concern, like personalized recommendation algorithms—present challenges that lie at the heart of securities regulation. To paraphrase one colleague who offered comments on the *Gamification and Securities Regulation* paper at an academic conference earlier today, digital engagement practices lay bare many of the contradictions in securities regulation policy—and in what the SEC, FINRA, and state regulators are trying to accomplish.

I thank you for your consideration. Please let me know if I can be of further assistance to the Commission, the Commissioners' counsel, or the Staff as the agency considers these issues further. For questions and additional information, please contact me by mail at the address below or by email at jtierney4@unl.edu.

Sincerely,

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