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Robinhood, the Fintech Discount Broker: Recent Developments and Concerns

Founded in 2013, Robinhood is an online and phone app-based discount broker-dealer for retail customers with an interest in trading stocks, stock options, exchange traded funds (ETFs), and cryptocurrencies. It is part of a new breed of *fintech* firms—innovative, technology-focused firms offering financial products. The firm is seen by some as "democratizing" access to retail securities trading; has been accompanied by industry consolidation; and has raised various public policy and congressional concerns.

The firm recently burst into the public eye for three major reasons: (1) it pioneered the now-widespread industry practice of charging zero trading fees or commissions for certain trades when the most inexpensive online brokers were charging $5 to $8 per trade; (2) in March 2020, its trading services shut down for more than a trading day in a period of market turmoil; and (3) in June 2020, a 20-year-old college student, Alex Kearns, committed suicide after his Robinhood app indicated that he had a negative balance of $750,000 for sophisticated stock options trades, an amount that now appears to have been grossly overstated.

Broker-dealers act as brokers when they execute securities trades for their clients and as dealers when they trade their own securities for their own benefits. Most broker-dealers must register with the Securities and Exchange Commission (SEC) and generally must be members of and comply with the rules and guidance of a self-regulatory organization (SRO), the Financial Industry Regulatory Authority (FINRA, an SEC-regulated nonprofit). In addition, broker-dealer sales personnel (also called registered representatives) register with their state.

SEC-registered broker-dealers are largely regulated under the Securities Exchange Act of 1934 (P.L. 73-291). Broker-dealers, or simply brokers, have significant range in the kinds of services they provide and generally divide into two groups: full-service (who provide research and advice, retirement planning, tax advice, etc.) and discount online brokerage firms. Historically, discount online brokers, such as TD Ameritrade, E*TRADE, and Merrill Edge, have charged lower trading fees than the full-service firms, but they have not provided individual investment advisory services.

Thanks in part to ads highlighting its zero trade commissions, seemingly pitched largely at millennials, by May 2020, Robinhood had reportedly attracted some 13 million clients with a median age of 31. Of that total, 3 million were reportedly added during the first four months of the year. As part of the firm's appeal to its generally youthful traders, observers cite that Robinhood's phone app's trading interface has design elements similarly to video games, including an explosion of screen confetti when a trader makes a trade. As reported in the *Financial Times*, one user, a Harvard University Ph.D. economics student observed that the "gamified" interface makes trading "so simple that it can be easy to make impulsive decisions." The view is shared by various behaviorists, but is rejected by firm officials.

Trading in Stock Options

Like its online competitors (e.g., Schwab, TD Ameritrade, E*TRADE), Robinhood witnessed an unprecedented surge in retail trading during early 2020. Alphacution, a research firm, found that compared with other retail brokers, Robinhood's customers trade the riskiest products at the greatest frequencies. This is said to be especially true for stock options—contracts that give investors the right to buy or sell shares at a specific price in the future. Robinhood reports options are traded by 12% of its active traders. In the aftermath of the Kearns suicide, stock option trading at the firm has become a central focus. Mr. Kearns had been trading an advanced form of stock option.

Analysts say that various advanced stock options can have substantial financial liability. A *US News & World Report* profile of stock option trading observed, "The statistics and the horror stories of huge losses demonstrate how dangerous option buying can be, especially for inexperienced traders."

FINRA's generic broker rule, Rule 2090, the "know your customer rule," requires option traders to get a broker's permission to move to more advanced options trading tiers based on broker-determined criteria. Depending on the broker, the criteria may include client characteristics such as options-trading experience, net worth, and age. Robinhood, a member of FINRA, provides for increasingly advanced and potentially more profitable but riskier levels of options trading.

According to the *Wall Street Journal*, Robinhood has imposed less rigorous hurdles to options trading than do its various rivals. New clients reportedly take a questionnaire-based self-assessment, must acknowledge the trading risks involved, and promise to read the broker's materials on options trading. If clients say that they lack an options investing background, they cannot initially open an options trading account. According to the *New York Times*, the Robinhood app then subsequently tutors them "to change the answer to 'not much' experience, which opens the door for them to trade."

In June 2020, on the heels of the suicide, Robinhood's owners said that they had been plagued by shortfalls in customer service personnel, which they said were being addressed. They also announced several safeguards. Among them are improvements to the user interface; the provision of enhanced educational resources for options traders; and the consideration of adopting more stringent eligibility criteria for certain options trades.

Zero Commissions and Payment for Order Flow

Like many of its rivals, Robinhood subsidizes its zero trading commissions through other cash generation mechanisms. Among them, the firm collects interest on margin loans and charges traders for professional research. Its principal cash generator is reportedly a practice called payment for order flow (PFOF). Often described as the lifeblood of discount brokers, PFOFs are rebates given by securities exchanges or market makers (firms that buy and sell securities for themselves) to brokers for routing trade orders to the firms for execution. Robinhood earned $100 million from the payments in the first quarter of 2020.

Major PFOF market makers are two high-frequency traders, Citadel Securities and Virtu Financial. Data from Alphacution indicate that Robinhood receives much more per share in PFOFs for its stock trades than do its online competitors. Some observers say that market makers' willingness to pay such a premium stems from the fact that the firm's clients tend to make exceptionally "uninformed" trades, which can create better profit-making opportunities for the market makers.

Proponents of the controversial PFOFs argue that by incentivizing larger volume trades, economies of scale are generated. In turn, this is said to help generate trading efficiencies that can translate into savings for investors (as in the zero trading fees). Proponents also argue that PFOFs are subject to a required FINRA trading protocol called *best execution*, whereby brokers must "use reasonable diligence" in determining the best market for a given security that is being bought or sold and so that the resulting share price is as favorable to the client as market conditions allow. Critics, including former SEC Chair Mary Jo White, have said that PFOFs may create potential conflicts of interest between brokers and clients, possibly undermining the quality of best execution. Representative Sean Casten, a member of the House Financial Services Committee, argued to *Barron's* that because Robinhood's profits disproportionately come from the payments, he alleged that it had an incentive to motivate its clients to trade more often. Attempting to assuage such concerns, firm officials told *Barron's* that over time, their clients tend to become longer-term "buy and hold" investors.

Robinhood's owners have argued that because they receive the same rates from all market makers that they route to, there are no conflicts of interest. A determining factor on whether a broker fulfills the best execution mandate can be whether it considers the opportunity for something called price improvement, when a trading order is executed at a better price than what is currently publicly quoted. Unlike its competitors, Robinhood reportedly does not report this.

On December 19, 2019, FINRA announced that it had reached a $1.25 million settlement with Robinhood over best execution violations stemming from PFOFs that occurred between October 2016 and November 2017. The company noted that the issues laid out in the settlement do not reflect how it currently operates. In September 2020, the *Wall Street Journal* reported that the SEC and Robinhood were negotiating a settlement based on the firm's alleged failure to fully disclose its PFOFs. Under rules 606 and 607 of Reg NMS of the Securities Exchange Act of 1934, key aspects of PFOFs must be disclosed.

In February 2020, FINRA announced that it had written to unidentified brokers who have adopted zero trading fee policies. Among other things, the "sweep examination" asked whether "changing to the zero-commission model resulted in changes to a firm's routing practices, execution quality, regular and rigorous review policies or the level of trading rebates or payment for order flow." Responses may help inform future regulatory moves.

Congressional Concerns

The Kearns's suicide note reportedly read, "I was a 20-year-old with no income able to be assigned almost a million dollars worth of leverage.… I had no clue what I was doing.... " Various Members of Congress have been scrutinizing Robinhood in the tragedy's aftermath.

In July 2019, Representatives Brad Sherman, Bill Foster, Lauren Underwood, and Sean Casten and Senators Richard Durbin and Tammy Duckworth wrote to Robinhood's two owners. The letter stated, "By seeking to cultivate a customer base of relatively inexperienced investors, you have also taken on an especially great responsibility to make sure your customers are protected and always provided with clear and accurate information." The firm was also asked if it assesses a client's age and experience before a client can trade complex stock options.

Outside of Congress, some experts have similar concerns. For example, Micah Hauptman, financial services counsel at the consumer advocate, the Consumer Federation of America (CFA), told the *Wall Street Journal*, that "firms [such as Robinhood] are making it way too easy to trade options … making it seem very attractive or low-risk."

As reported in *Roll Call*, some Members of Congress, including Chairman Brad Sherman and Representative Sean Casten, see Robinhood as failing to comply with existing broker regulatory rules, a view shared by the CFA's Hauptman. To date, FINRA reports that there are no such disciplinary actions against the firm.

Potential Regulatory Lag

A problem often posed by fintech firms is that existing regulations may have some obsolete aspects in their applicability to them or their innovative products, a phenomenon called regulatory lag. At a House Financial Services Subcommittee hearing on June 25, 2020, SEC Chair Jay Clayton said his agency and FINRA would be coordinating to improve unspecified disclosures in this area.

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