BETTER MARKETS

– FACT SHEET –

Reddit, Robinhood, GameStop & Rigged Markets: The Key Issues for Investigation

February 1, 2021[1]

The Reddit-fueled and Robinhood-facilitated frenzied trading of GameStop and a number of other public companies have raised serious investor protection and market integrity issues. Indeed, it has exposed a vast predatory ecosystem underpinning too much of modern finance, including the anti-retail trader, anti-buy side practices enabled by a rigged market structure. These events have, once again, also exposed the need to investigate the conduct of numerous financial firms and market intermediaries, including brokers, hedge funds, dealers, short sellers and Wall Street's megabanks. And it calls for renewed scrutiny into trading practices that have become ingrained in the markets, including leverage, liquidity, derivatives, fragmentation, complexity, interconnectedness, high frequency trading, the gamification of retail trading, market manipulation and conflicts of interest.

The equities markets are supposed to facilitate price discovery and allocate capital to its optimal use through fair, orderly, and efficient trading. Recent events related to Reddit, Robinhood, GameStop and other stock trading unrelated to any fundamental, company specific information or rational basis risk shattering investors' trust and confidence both in the markets and in the regulators who are supposed to protect those markets and their participants. Those regulators have very powerful investigative tools and have full authority to stop and punish fraud, market manipulation, false and misleading statements as well as the full panoply of disclosure violations.

Contrary to much self-interested spin, ***this is not a game***. There are lots of real people who are going to lose billions of dollars in connection with this market frenzy and not just hedge funds and other sophisticated financial firms shorting particular stocks. Just like housing values in connection with the 2008 financial crash, stock prices do not only go up. They will go down and they can go down far and fast, hurting retail investors and many others, often in unanticipated ways.[2]

While there is much that we don't yet know, policymakers, regulators and prosecutors, from Congress, the SEC, CFTC,[3] Federal Reserve and the Department of Justice (as well as Treasury's Financial Stability Oversight Council),

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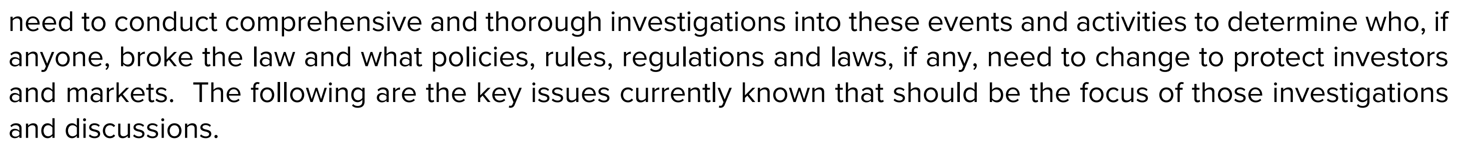
[1] Given the fluid and fast-moving events discussed herein, this document will be updated or supplemented as appropriate as additional information becomes available.

[2] *See, e.g.*, Matt Egan, "*Apparent suicide by 20-year old Robinhood trader who saw a negative $730,000 balance prompts app to make changes*," CNN (June 20, 2020), *available at* https://www.cnn.com/2020/06/19/business/robinhood-suicide-alex-kearns/index.html.

[3] The Commodity Futures Trading Commission (CFTC) must be involved in these investigations because of the apparent use of derivatives (particularly OTC swaps) as well as synthetic shorting and leverage and more recent reports of markedly increased retail activity in various commodities markets.



need to conduct comprehensive and thorough investigations into these events and activities to determine who, if anyone, broke the law and what policies, rules, regulations and laws, if any, need to change to protect investors and markets. The following are the key issues currently known that should be the focus of those investigations and discussions.

Ripping Off Retail Traders

Robinhood appears to be the opposite of the legendary character it purports to be; in fact, a more accurate name might be "Robbin' its Clients." First, too many of the trades on Robinhood enrich sophisticated trading firms and billionaires at the expense of Robinhood's traders. Second, Robinhood enriches itself by selling its clients' orders to so-called market makers or so-called internalizers that are high-frequency traders.[4] This is not unique to Robinhood. This is a widespread, common industry practice at retail broker-dealers. (Tellingly, this was an unlawful practice at Robinhood until recently due to its failure to disclose it did this and the fact that those practices at times adversely affected the prices its clients received on their orders.)

Payment for Order Flow (PFOF): Legalized Bribery

It has been reported that Robinhood was paid more than $450 million in 2020 alone for selling its clients' orders to trading venues, which is called "payment for order flow" or PFOF (also referred to as "maker-taker" fees and rebates). Because PFOF incentivizes brokers like Robinhood to send their clients' orders to the highest bidder, many see the practice as nothing more than a form of legalized bribery that further advantages already dominant high frequency trading firms and too often results in everyday investors paying more for stock than they otherwise would.

The dealers buying that order flow execute the orders and, of course, make money in doing so, presumably multiples of the $450 million they paid Robinhood for that order flow. For example, dealer Citadel Securities, owned by hedge fund billionaire Ken Griffin, appears to be the biggest recipient of Robinhood's order flow, reportedly handling "29% of GameStop trading volume Monday through Thursday" last week.[5] Thus, Robinhood's clients' trading advantages and enriches billionaires like Ken Griffin, whose Citadel Securities had net trading revenue of $6.7 billion just last year (which does not include the billions presumably pocketed via the Citadel hedge fund).[6] That would appear to be the opposite of robbing from the rich and giving to the poor.

There is a good argument that most of the PFOF money should have gone to or at least been shared with Robinhood's clients, especially in light of the SEC settlement revelations that its clients unknowingly exchanged "commission-free" trades for inferior execution (which can be far more costly to the investors than commissions). In any event, those investors were entitled to the best execution available in relevant markets conditions, which they apparently did not receive as required by law.

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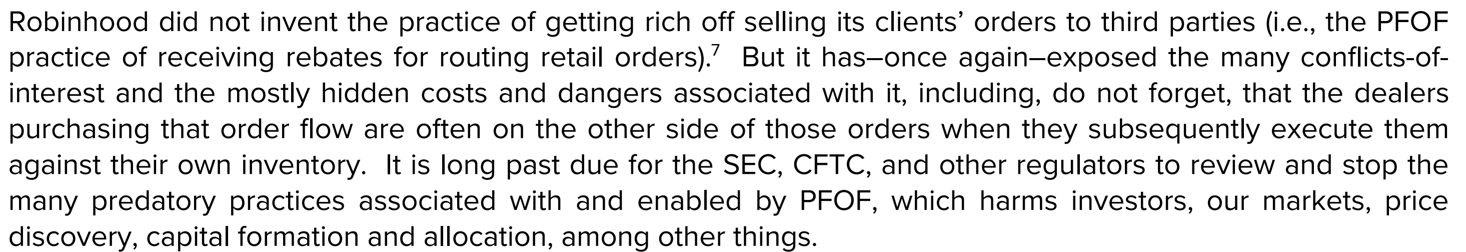
[4] It does this by receiving hundreds of millions of dollars of so-called "rebates" from market makers and dealers for routing its clients' orders to those market makers and dealers, who make claims about best execution, etc.

[5] Alexander Osipovich, *GameStop Frenzy Puts Spotlight on Trading Giant Citadel Securities*, Wall St. J. (Jan. 31, 2021), available at https://www.wsj.com/articles/gamestop-frenzy-puts-spotlight-on-trading-giant-citadel-securities-11612089000?mod=searchresults_pos2&page=1 (also reporting that 73% of all "U.S. retail stock trading volume goes through Citadel Securities" and Virtu Financial).

[6] This of course raises a myriad of other issues regarding how Citadel (and the many other similarly structured market participants) manages and handles order data and how it maintains "walls" between the various activities, all of which policymakers, regulators and prosecutors should carefully examine.



Robinhood did not invent the practice of getting rich off selling its clients' orders to third parties (i.e., the PFOF practice of receiving rebates for routing retail orders).[7] But it has–once again–exposed the many conflicts-of-interest and the mostly hidden costs and dangers associated with it, including, do not forget, that the dealers purchasing that order flow are often on the other side of those orders when they subsequently execute them against their own inventory. It is long past due for the SEC, CFTC, and other regulators to review and stop the many predatory practices associated with and enabled by PFOF, which harms investors, our markets, price discovery, capital formation and allocation, among other things.

Fraudulent and Misleading Claims of "Free Trading"

Of course, a key to keeping this lucrative scheme going and the money flowing to brokers, dealers and so-called market makers is to make sure retail traders do not know that lots of people are getting rich off of their orders. That appears to be why Robinhood allegedly broke the law and paid a $65 million fine (without admitting to any wrongdoing) to settle an action by the SEC last December for not telling its clients that it was selling their orders and making a ton of money in PFOF.[8] The other key part of the scheme is the trumpeted misleading claim of "commission free trading," which too many traders hear as "free trading." Unsurprisingly, given the well-known behavioral science that "free" goods or services (or those believed to be "free") tend to be over consumed, retail trading has skyrocketed since the industry started de facto selling "free trading."

As is clear from the billions paid for order flow and the billions made from executing those orders, there is no such thing as "free trading." Thus, the claim of "commission free trading" is often no more than a rhetorical ruse to attract new investors and distract from the billions of dollars in PFOF and other hidden costs that ultimately come out of retail investors' pockets. It's pretty clear that these intermediaries are often merely transferring the investors' visible upfront commissions into invisible after-the-fact de facto commissions.[9] This has been enabled by the created complexity of the fragmented order processing system that one could argue is designed primarily to hide those payments.

Among many other things, the SEC should consider taking the position that the claim "commission free trading" is materially misleading to a reasonable investor. In addition, the SEC should consider requiring brokers like Robinhood making any claim that suggests or could be interpreted as "free trading" to specifically, clearly and in plain English disclose all of the indirect and unseen fees and costs (broadly defined) to the trader associated with placing an order, including but not limited to PFOF. That, however, would not necessarily disclose all of the direct and indirect revenue received by all the intermediaries that touch a given trade and the SEC should consider how best to require that information to be disclosed to traders and the markets.

The Gamification of Trading

Compounding that lure of "free trading" claims is the gamification of trading, which Robinhood seems to have perfected by incorporating the addictive game features of more benign apps into its trading app for the purpose of triggering more trading. Thus, it is taking an activity – investing and risking money – that has historically been

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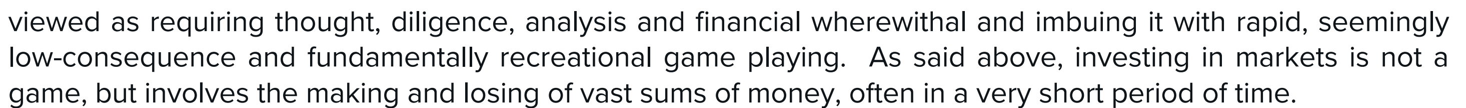
[7] *See, e.g.*, Carl Levin, *Time to stop trading conflicts that cost investors billions*, the Financial Times (Jan. 11, 2020), *available at* https://www.ft.com/content/8a88d1e9-8a76-47c3-9fb7-b720fab55f5d.

[8] In Re Robinhood Financial, *available at* https://www.sec.gov/litigation/admin/2020/33-10906.pdf. Other issues raised by this case are the SEC's continual failure to charge (1) firms like Robinhood with fraud rather than mere disclosure violations, and (2) the individuals who broke the law rather than just the financial firm. Any fair reading of the facts in this settlement agreement would seem to make out a pretty clear case of intentional fraud.

[9] This is not to suggest that all investors are harmed at all times. No doubt, some investors benefit from commission-free trading and these order routing practices some of the time, but, when analyzed holistically and comprehensively, investors and markets appear to be overwhelmingly disadvantaged.



viewed as requiring thought, diligence, analysis and financial wherewithal and imbuing it with rapid, seemingly low-consequence and fundamentally recreational game playing. As said above, investing in markets is not a game, but involves the making and losing of vast sums of money, often in a very short period of time.

Regulators should, at a minimum, review (1) whether a broker-dealer registered with and ostensibly regulated by the SEC can satisfy its legal duties to its investor clients with such a product, and (2) whether broker-dealers, in practice, are balancing the communications and interfaces emphasizing the profitability and ease of trading with equally compelling and conspicuous information concerning the risks of trading, including the risk of substantial losses. The latter would be especially important with respect to options trading that reportedly have been at the center of GameStop's rapid and irrational price increases to market values far in excess of other companies with substantially more fundamental value support.

Interestingly, it appears that the same type of endorphin-engendering game playing is part of the business model of Reddit, which, while not a registered broker-dealer, should be scrutinized as well. In addition, reports that registered representatives currently employed by SEC registered broker-dealers acting under pseudonyms in Reddit require especially careful regulatory scrutiny.[10] But, that investigation should not be limited to Reddit or a particular chat, but must include analyzing the role social media more broadly plays in today's markets and what additional rules or laws, if any, might be appropriate.

Market Manipulation

Investigators must also focus on scrutinizing at least two possible forms of market manipulation. First, the chat rooms where many retail investors appear to be getting their information and perhaps coordinating their trading must be reviewed. While many traders are likely sharing accurate information and genuine enthusiasm, the SEC should determine whether there is any evidence of market manipulation, ranging from standard "pump and dump" schemes to professionals possibly violating their legal duties,[11] among a variety of other questionable and possibly manipulative and illegal practices.

Second, for years, hedge funds and other professional market participants have engaged in the systematic shorting of targeted stocks ostensibly based on the fundamental analysis view that they are overpriced. However, it appears that some also short stocks on the non-fundamental view that significant shorting in itself will cause those stocks to fall in price, allowing the shorts to reap huge profits. Unlawful fraud and manipulation may underlie many of these and related practices, which regulators need to thoroughly analyze.

Unfair and Inadequate Remedies for Retail Investors When Ripped Off

As is becoming widespread in far too many areas, almost all financial firms require their clients to sign lengthy, complicated agreements that, among other things, force them to address any and all disputes in arbitration. In this case, that not only applies to Robinhood and the other financial firms, but Reddit also reportedly requires users to sign similar agreements.[12]

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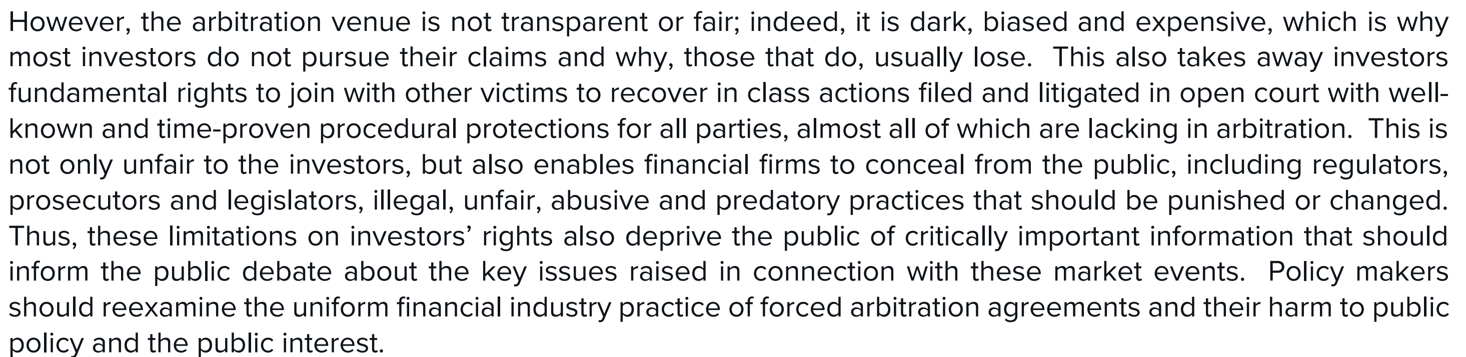
[10] *See, e.g.,* Pam and Russ Martens, *GameStop Promoter Keith Gill Was No 'Amateur' Trader; He Held Sophisticated Licenses and Worked in the Finance Industry*, (Jan. 30, 2021), *available at* https://wallstreetonparade.com/2021/01/gamestop-promoter-keith-gill-was-no-amateur-trader-he-held-sophisticated-trading-licenses-and-worked-in-the-finance-industry/.

[11] *See, e.g.,* note 8 above.

[12] Tom Hals, *Analysis: Robinhood and Reddit protected from lawsuits by user agreement, Congress*, Reuters (Jan. 30, 2021), *available at* https://www.reuters.com/article/us-retail-trading-robinhood-liability-an-idUKKBN29Z0HI?taid=601575a459acd30001ef2602&utm_campaign=trueAnthem:+Trending+Content&utm_medium=trueAnthem&utm_source=twitter.



However, the arbitration venue is not transparent or fair; indeed, it is dark, biased and expensive, which is why most investors do not pursue their claims and why, those that do, usually lose. This also takes away investors fundamental rights to join with other victims to recover in class actions filed and litigated in open court with well-known and time-proven procedural protections for all parties, almost all of which are lacking in arbitration. This is not only unfair to the investors, but also enables financial firms to conceal from the public, including regulators, prosecutors and legislators, illegal, unfair, abusive and predatory practices that should be punished or changed. Thus, these limitations on investors' rights also deprive the public of critically important information that should inform the public debate about the key issues raised in connection with these market events. Policy makers should reexamine the uniform financial industry practice of forced arbitration agreements and their harm to public policy and the public interest.

Rigged Markets

Rigged markets and general awareness that they are rigged–including by policymakers, regulators and prosecutors–are not new. This has been repeatedly and starkly highlighted over the years, including in the 2008 financial crash, when Michael Lewis' 2014 book Flash Boys caused a sensation, followed the 2010 "flash crash," and in frequent mini-flash crashes and other market "anomalies" over the years. While each have received varying degrees of attention, regrettably none have resulted in meaningful regulatory or other action that protects investors or markets.[13] While it remains to be seen if there will be any reforms this time, continued market mayhem confirms yet again that today's markets are riddled with conflicts of interest and unethical abusive practices, if not rigged in fundamentally unfair and opaque ways against everyday investors and the buy side more generally.

Conflicts of Interest

There are far too many conflicts of interest distorting today's markets. For example, Citadel owner and billionaire Ken Griffin's hedge fund has direct and indirect investments in and activities related to equities its affiliate, Citadel Securities, makes markets and trades in. Furthermore, Citadel, which already had $1 billion invested in Melvin Capital Management, reportedly provided a $2 billion lifeline last week to Melvin, a hedge fund that reportedly lost a fortune shorting GameStop and other stocks.[14] According to reporting, that means that Citadel Securities was making a fortune off of Robinhood's clients who were taking long positions on GameStop while at the same time Citadel invested in and provided emergency funding to hedge funds with massive short positions in the very same stocks. Those activities raise numerous other questions: Melvin's bets, like most hedge fund bets, were reportedly highly leveraged. Who enabled Melvin's borrowings and who was making the margin calls that reportedly necessitated the bailout? Who were the securities lenders to Melvin and other GameStop shorts?

Short-selling Activity

It appears that the net available float of GameStop stock actually available to trade was insufficient to cover the short positions. In fact, one report indicated that hedge funds were able to short-sell 140% of the total float of GameStop. In addition to questions about compliance with the uptick rule, Regulation SHO, short selling requirements and other regulatory matters, investigators must determine whether Goldman Sachs, Citigroup or

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[13] The one major reform that was supposed to result from the "flash crash" was the creation of a consolidated audit trail (CAT), which was regrettably outsourced to the conflict-ridden industry and, no surprise, is still years away from being completed. As a result, investigators here will once again not have state-of-the-art tools to do their job quickly or efficiently. If nothing else comes out of this, Congress and the SEC simply must make the CAT a reality within the next year. After all, it is unconscionable that private market participants like Citadel and all of Wall Street's biggest financial firms have knowledge and data about today's markets than are far superior to that readily available to the primary regulator of those markets, let alone advance access to market trading data that retail investors lack.

[14] Juliet Chung, *Citadel, Point72 to Invest $2.75 Billion Into Melvin Capital Management*, Wall St. J. (Jan. 25, 2021) *available at* https://www.wsj.com/articles/citadel-point72-to-invest-2-75-billion-into-melvin-capital-management-11611604340.

other dealers or prime brokers commonly used by hedge funds have designed derivatives products that facilitated synthetic shorts not reported in the short interest. Recall that in the years before the 2008 crash, hedge funds like John Paulson's wanted to short the housing market and Goldman[15] and others[16] created vehicles like Abacus for them to do just that. In addition to analyzing the short positions, products and related activities, investigators must also review all the communications between the shorts and their affiliates to determine if there was any collusion, manipulation, or other violation of law.

Trading Halts and Limitations

The many trading halts by the exchanges, Robinhood and any others also need to be closely examined. The theory behind the exchanges' halts (often called "circuit breakers") is that such "time-outs" enable investors to obtain and process additional information, reassess trading interest, and re-populate order books, which is supposed to inform subsequent trading and restore order to what is believed to be otherwise uninformed or even misinformed panicky trading. It is not clear that happened here given that the mania driven trading continued largely unabated after the halts were lifted. Understanding why trading interest and behavior appeared unchanged will be critical to evaluating the current exchange trading halt structures and procedures.

However, Robinhood's multiple asymmetric and apparently ad hoc trading halts also have to be closely examined. Citadel denied it, but it was reported that Citadel ordered or suggested that Robinhood stop the trading in GameStop and other names, possibly to protect its direct or indirect short positions.[17] Even if that turns out to be unfounded speculation, it remains quite unusual for a retail broker-dealer to halt trading allegedly on only one side of the market, in a handful of names, only to reopen trading the next business day. Moreover, this is unusual also because it appears that many of the traders halted on account of Robinhood's actions were likely in the money by a fairly substantial amount.

Robinhood subsequently stated that it was essentially forced to halt trading in light of the extraordinary volatility in GameStop and to set aside or obtain additional funds to protect against defaults and to meet clearing requirements. This raises a host of issues, including whether Robinhood had a sufficiently robust compliance and controls framework for deciding if and when to halt trading and whether net capital and liquidity requirements sufficiently account for the nature and magnitude of trading through the largest retail broker-dealers. Either way, ad hoc trading halts clearly favor the positions of certain investors over others and need to be closely examined.

On top of that, Robinhood's most recent dramatic limitations on its clients' trading in numerous stocks to just one share, among other restrictions, are unprecedented. There is little dispute that this greatly impairs those clients' trading ability, at least on the Robinhood platform. The many issues raised by these actions need to be thoroughly examined by all the regulators as well.

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[15] "SEC Charges Goldman Sachs with Fraud in Structuring and Marketing of CDO Tied to Subprime Mortgages," (April 16, 2010), *available at* https://www.sec.gov/news/press/2010/2010-59.htm#:~:text=According%20to%20the%20SEC's%20complaint%2C%20the%20deal%20closed%20on%20April,for%20structuring%20and%20marketing%20ABACUS.

[16] *See, e.g.*, "Citigroup to Pay $285 Million to Settle SEC Charges for Misleading Investors About CDO Tied to Housing Market," (Oct. 19, 2011), available at https://www.sec.gov/news/press/2011/2011-214.htm.

[17] The actions, communications and suggestions related and proximate to Robinhood's trading stops need to be closely examined with the famous quote attributed to King Henry II about the Thomas Becket firmly in mind: "Will no one rid me of this meddlesome priest?"

Conclusion

There is little doubt that today's financial market are littered with multiple layers of legalized bribery, including PFOF and market manipulation that enriches the financial industry's biggest firms and intermediaries at the expense of investors, price discovery, capital formation, and the orderly functioning of markets. There is no reason for the markets today to be so fragmented other than to serve as a wealth extraction mechanism that moves money from buy-side pockets to sell-side firms, intermediaries and their affiliates.

So, the conclusions thus far based on what little is currently known are twofold. To be sure, first, there should be a thorough investigation into the market mayhem precipitated by the so-called Reddit rebellion ignited in the subreddit community of WallStreetBets and apparently implemented by Robinhood's retail army. However, second, that must not be allowed to obscure the need for a much broader and deeper investigation into the fragmented predatory financial ecosystem that enables such mayhem. For example, the biggest Wall Street banks and their subsidiaries and affiliates enable, fund and facilitate many of those trading practices because those banks are also (1) the prime brokers for most of the hedge funds, (2) the biggest derivatives dealers, (3) major market makers, and (4) significant lenders in various capacities including as securities lenders, while also playing numerous other roles in the financial system and, undoubtedly, in the transactions and activities at issue here.

Thus, while the direct and obvious participants in the market chaos like Robinhood, Reddit, Citadel, and the short sellers must be intensely scrutinized, the many other financial firms, including the marquee Wall Street banks, driving, enabling, funding and incentivizing these activities -- and enriching themselves from them -- must also be thoroughly reviewed.

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