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A Real Robin Hood on Wall Street: Democratizing Equity Markets Without Exploitation

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Wall Street has been too exclusive, expensive, opaque, and complicated for way too long. Much of that is intentional and by design to enable large, entrenched financial firms to extract wealth from the unwary or mislead. That presented an opening for upstart firms to pitch Main Street investors, claiming that they were going to "democratize Wall Street" with easy access to stock market riches and less expensive if not free financial products and services.

But, of course, riches don't come easy, and nothing is free on Wall Street. Such claims are often just cover for manipulation and exploitation. In this case, one financial firm in particular, Robinhood, also used slick marketing, predatory app features, hip/cool logos, and a legendary name to disguise the owners' get-rich-quick schemes (in addition to outright illegal conduct for which it has been sanctioned by regulators repeatedly).

This, however, isn't how it has to be. Equity markets and finance more generally can be genuinely "democratized" (meaning lower costs, easier access, a more delightful experience, etc.) without exploitation, manipulation, and predators enriching themselves at the expense of retail investors and the buy side more generally. All of that and more is discussed in a law review article written by Better Markets that appeared in the Western New England Law Review entitled "Democratizing Equity Markets With and Without Exploitation: Robinhood, GameStop, Hedge Funds, Gamification, High Frequency Trading, and More" which can be read in full here.

This pandemonium all burst into the public consciousness in January 2021, when a media frenzy reported on a trading frenzy that erupted in the stock market around so-called "meme stocks" such as Blackberry, AMC, and, most notably, GameStop, whose value skyrocketed to unimaginable heights despite dim business prospects. For example, over the course of just 16 days, from January 11 to January 27, GameStop's share price rose by **1,600%** even though it was highly unlikely, to say the least, that GameStop's business prospects improved by 1,600% in just over two weeks.

The trading frenzy was fueled in significant part by an army of retail traders discussing which meme stocks to trade on forums such as Reddit's "r/wallstreetbets." Many of those traders were also determined to beat the Wall Streeters at their own game by inflicting harm on hedge funds thought to be bad actors for unfairly targeting certain companies. Because those hedge funds had substantial short positions in those companies, many of those retail traders decided to execute a short squeeze. This became known as the

"Reddit rebellion," which inflicted billions of dollars of losses on several hedge funds, and ultimately driving one (Melvin Capital) into liquidation.

The weapon of choice by many of those trading the meme stocks like GameStop stock were mobile phone-based apps like Robinhood, which offered so-called "commission-free" trades, and a supposedly fun and engaging user interface that makes stock trading easy and enjoyable if not a "delightful" experience. These are the primary reasons Robinhood claims to "democratize finance" and bring the riches of Wall Street to Main Street.

However, in January 2021, Robinhood suddenly prohibited its retail customers from buying GameStop and other meme stocks, which precipitated sudden and dramatic price declines resulting in huge losses for the many retail traders who bought near the top or the stock on the way up. This raised serious questions about the way Robinhood made its money and its relationships with other Wall Street players like Citadel and other high frequency trading firms.

While no evidence has emerged suggesting anything illegal with regard to the buying halt, Robinhood and other trading apps, despite claiming to "democratize finance" for their retail users, this conduct highlighted the powerful Wall Street firms who are Robinhood's real customers and how they all enriched themselves at the expense of retail traders. As we explain in the law review article, apps such as Robinhood do this by taking advantage of "payment for order flow" (PFOF). PFOF is when retail brokers like Robinhood sell their retail customers' orders to the highest bidder. The revenue from PFOF is what enables them to offer what they call "commission-free trading." Unfortunately, too many traders hear that claim as "free trading," which it definitely is not. In fact, the SEC enforcement action against Robinhood proved that the PFOF revenue extracted from the retail traders' orders exceeded what they would have paid if charged a commission. In addition, to maximize the revenue earned from the PFOF practice, trading apps use predatory "digital engagement practices" and other gamification techniques to get users to thoughtlessly trade more often and to trade riskier products.

Bringing these predatory practices to Main Street and ripping off hardworking Americans isn't democratizing Wall Street; it is enriching Wall Street at the expense of Main Street, often from those least able to afford the losses that pay for the chauffer-driven cars, private planes, mansions, and other luxuries the Wall Street billionaires buy with their ill-gotten gains. What Main Street investors need is a modern-day Robin Hood who doesn't take from the rich to give to the poor, but provides Main Street investors genuine opportunities to trade, invest, and build wealth in the equity markets. That democratization can be – and must be -- done without exploitation.

Payment for Order Flow

In the 1980s Bernie Madoff, who would later operate a notorious Ponzi scheme but who then a market-maker focused on technological innovation, recognized that he could make a tidy profit if he could convince brokers to route their trades, i.e. order flow, to his firm for execution. He also realized he could only make this tidy profit if the orders he received were largely uninformed about the direction of the market. Thus, he began paying brokers for their retail orders—an attractive prospect for brokers who were then **paying** 3 cents a share to NYSE for trade execution. The concept of retail payment for order flow (PFOF) was born. This practice was of course lucrative for brokers, and also for the high-frequency trading ("HFT") firms that buy those orders and make money by collecting the spread between what they are willing to buy a stock for (the bid), and what they are willing to sell the stock for (the offer).

But PFOF has proven harmful for investors and the markets. It creates a clear conflict of interest for brokers, who are obligated to seek best execution of client trades. But if brokers are selling their orders to the highest bidder, can they really be expected to seek best execution? This inherent conflict is perhaps best exemplified by a December 2020 SEC enforcement action against Robinhood, in which Robinhood made public statements that it gave its users superior execution, even though it knew based on its own internal analysis that its acceptance of unusually high PFOF payments led to significantly worse execution quality than its competitors. Worse, the SEC found that Robinhood customers lost $34 million from Robinhood's order execution practices compared to what they would have received at other brokers, **even after accounting for the $5 per trade commission those brokers charged**. This illustrates an important point—PFOF may enable brokers to offer trading without commission, but so-called "commission-free" trading is not the same as "cost-free" trading. Instead, this practice transforms an upfront, visible, fixed cost, into a hidden, variable cost from which retail brokers like Robinhood and high frequency trading firms like Citadel make billions of dollars. This does not benefit retail investors. PFOF also harms markets by contributing to market fragmentation, and in particular by routing orders to HFT firms who either execute the trades against their own inventory, or route to non-public "dark pools," meaning those orders never have a chance to interact with orders on public exchanges.

PFOF Fuels Gamification and Other Predatory Digital Engagement Practices that Harm Retail Users

The economics of PFOF mean that brokers make more money when their clients trade more frequently. It also means that brokers make more money the riskier those trades—HFT firms profit from buying order flow by pocketing the spread between the bid and offer, and those spreads are bigger for less liquid and riskier products, such as options. Thus, brokers can make more money from PFOF by getting customers to trade more and in riskier products, and this is just what apps like Robinhood do through use of so-called "gamification" techniques and other predatory digital engagement practices ("DEPs") that are "built on a Silicon Valley playbook of behavioral nudges and push notifications, which has drawn inexperienced investors into the riskiest trading."

The predatory DEPs used by trading apps to lure users in and to encourage them to trade include offers of free stocks to get users to sign up, misleading claims of "commission-free" trading, which plays on the well-known principle that people tend to overvalue, and thus use more of, products that are marketed as "free," and so-called "educational and informational" tools that are in fact designed to provoke thoughtless trading, by making it seem like information that should be acted on immediately, rather than careful deliberation. Moreover, apps like Robinhood have fueled a surge in options trading among retail customers by making it extraordinarily easy to trade these risky products in just a few short clicks, and actively encourages its users to do so.

Belying the purported promise of these apps to democratize finance, these predatory DEPs that encourage frequent and risky trading are harmful to retail users. It has long been known that retail participants who trade frequently perform poorly. This has, unsurprisingly, held true specifically for Robinhood's users. Similarly, retail participants have always done poorly when engaging in risky options trading. It's important to remember that behind these studies about poor trading performance is real human suffering, as has been documented in numerous stories in just the past few years: the HBO documentary "Gaming Wall Street" detailed numerous stories, including a self-described "upper middle" homeless" man who thought he might have found hope in GameStop stock only to be disappointed (although he eventually found some measure of stability, not thanks to stock trading, but due to a COVID stimulus check); in Vice a Robinhood user detailed how he lost **$400,000** on a single options bet; a Wall Street Journal Story detailed three friends who began trading on Robinhood during the pandemic, initially racking up big wins before suffering devastating losses; the New York Times told the story of a 32 year old Navy medic who fueled his trading on Robinhood with an initial $15,000 credit card cash advance, and then later a $60,000 home equity loan to cover his losses, ultimately suffered losses of nearly a million dollars—at the time of the article, he had less than half of his initial investment; and most tragically, the heartbreaking story of Alex Kearns, a 20 year old college student who traded options on Robinhood and who thought he could lose no more than $10,000, but who died by suicide after being led to believe he had lost more than $730,000.

It is important to note that retail traders do not consistently suffer losses from frequent trading and options trading because they are dumb, or because they do not understand the markets. Indeed, many retail participants surely have a good understanding of finance, business, and economics. The issue is that in the zero-sum game of stock trading, they are competing against sophisticated professionals, often with advanced degrees and access to the most state-of-the-art technology. What chance could anyone have against that? It would be like a local recreational baseball league team taking on the world champion Atlanta Braves. The local league players may well be pretty good, but the professional players on the Braves do nothing but play baseball every day, with access to the best coaches, the best equipment, the best training tools, and the best analytical techniques. What chance would they have? Robinhood is not leveling the playing field; it is encouraging its users to play a game it knows they have little chance of winning.

True Democratization is Possible, But Not From the Robinhood/PFOF Model

Finance can and should be democratized, but the Robinhood/PFOF model is not how. True democratization means making it easier for Main Street Americans to actually make money in the stock market. This is possible for retail investors, but highly unlikely if they engage in the frequent trading strategy Robinhood and other platforms that use predatory DEPs encourage. Rather, for most individual retail investors, using the stock market to make money and achieve realistic, but ambitious, financial goals typically means foregoing the often frequent attempt (and, yes, excitement) of making a quick buck, and instead opting for a longer-term buy-and-hold strategy that allows customers to take advantage of compound returns to increase their wealth. Put differently, it would enable and encourage customers to think of themselves as investors, not merely traders.

Regardless, Main Street traders and investors should not be exploited and manipulated by predatory sales, marketing, and trading techniques that use artificially generated thoughtless activity and endorphin highs to generate financial lows. Those Main Street Americans are still waiting for and deserve a real Robin Hood.

Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

1825 K Street, NW | Suite 1080 | Washington, DC 20006 | 202-618-6464 | www.bettermarkets.com