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GameStopped: How Robinhood's GameStop Trading Halt Reveals the Complexities of Retail Investor Protection

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GAMESTOPPED: HOW ROBINHOOD'S GAMESTOP TRADING HALT REVEALS THE COMPLEXITIES OF RETAIL INVESTOR PROTECTION

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ABSTRACT

Should brokers have the unfettered right to restrict investor trading? GameStop, a brick-and-mortar video game retailer, had been experiencing declining revenues since 2016. However, GameStop saw its share price climb almost 1000 percent in the span of a one-week period from January 21, 2021 to January 27, 2021 due to retail investors buying significant amounts of GameStop shares during that period. Melvin Capital, a hedge fund, ended up losing billions as they were betting that GameStop shares would lose value instead of increase—a practice referred to as short selling. On January 28, 2021, brokers inexplicably halted trading on GameStop shares thus capping any further losses to Melvin Capital while at the same time capping potential further gains for the retail investors.

Most of the retail investors were customers of one brokerage firm—Robinhood, Inc. for which Robinhood drew much criticism. Was Robinhood's decision to restrict trading a result of some financially commingled allegiance to Melvin Capital or was it driven by some other reason? Moreover, is trading in the public equity markets "rigged" to favor the big hedge funds and institutional investors to the detriment of retail investors?

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With the use of technology, online trading platforms, and social media, public trading markets are evolving resulting in unprecedent occurrences. Is the current regulatory environment properly situated to maintain a "fair and orderly" public trading market? Do brokerage firms need to reexamine their operating protocols in relation to their retail investors? This Article adds to the discussion by exploring these questions.

INTRODUCTION

On Thursday, January 28, 2021, Robinhood, a brokerage firm that provides no-fee online trading for retail investors, made the unprecedented decision to place restrictions on its retail investors, thereby denying them the ability to make further share purchases of the brick-and-mortar gaming retailer GameStop.[1] When Robinhood placed these restrictions, GameStop shares were selling at a high of $120.75 per share.[2] Notably, 6 days earlier, on January 22, 2021, the shares were selling at a high of only $19.19 per share.[3] Moreover, 2 weeks prior, on January 8, 2021, GameStop shares were selling at a high of $4.57 per share.[4]

Robinhood received harsh criticism for its decision to halt trading. In addition to retail investors, political influencers on both sides of the aisle criticized Robinhood as well. Billionaires such as Elon Musk[5] and Warren Buffet,[6] chastised Robinhood for denying retail traders the right to purchase shares in a publicly traded company.[7]

Critics asserted that Robinhood's decision to halt trading was due to some inappropriate conflict of interest entangling Robinhood.[8] These

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1. Matt Egan, *This App Completely Disrupted the Trading Industry*, CNN BUS. (Dec. 13, 2019), https://www.cnn.com/2019/12/13/investing/robinhood-free-trading-fractional-shares [https://perma.cc/E5KT-KAP5]; Megan Leonhardt, *Robinhood Now Faces Roughly 50 Lawsuits After GameStop Trading Halt—Here's How Customers Might Actually Get Their Day in Court*, CNBC: MAKE IT (Aug. 31, 2021), https://www.cnbc.com/2021/02/17/robinhood-faces-lawsuits-after-gamestop-trading-halt.html [https://perma.cc/5GJV-6VM7].

2. *GameStop Corp. (GME)*, YAHOO FIN., https://finance.yahoo.com/quote/GME/history?period1=1609459200&period2=1612137600&interval=1d&filter=history&frequency=1d&includeAdjustedClose=true&guccounter=1 [https://perma.cc/L482-VKKG] (last visited Mar. 1, 2023).

3. *Id.*

4. *Id.*

5. Puah Ziwei, *Elon Musk Clashes with Robinhood CEO Over GameStop Trading Ban*, NME (Feb. 2, 2021), https://www.nme.com/news/gaming-news/elon-musk-gamestop-robinhood-vlad-tenev-clubhouse-2870357 [https://perma.cc/MUG3-EVPW].

6. *Warren Buffett Criticizes Robinhood at Annual Meeting*, DEUTSCHE WELLE (May 2, 2021), https://www.dw.com/en/warren-buffett-criticizes-trading-app-robinhood-at-annual-meeting/a-57400954 [https://perma.cc/5RVE-T9RE].

7. Matt Egan, *A Week Later, Robinhood Removes Trading Restriction on GameStop and AMC*, CNN BUS. (Feb. 5, 2021), https://www.cnn.com/2021/02/05/investing/robinhood-gamestop-amc-reddit/index.html [https://perma.cc/DTM6-93UF].

8. Douglas MacMillan & Yeganeh Torbati, *Robinhood and Citadel's Relationship Comes into Focus as Washington Vows to Examine Stock-Market Moves*, WASH. POST

accusations suggested that Robinhood's "no fee commission" trading model had left Robinhood beholden to hedge funds that paid Robinhood to execute trades on Robinhood's behalf— a practice referred to as "Payment For Order Flow" ("PFOF").[9] PFOF is the compensation that "venues" pay to brokerage companies like TD Ameritrade (or Robinhood) in exchange for the brokerage company routing client orders to the venue instead of sending those orders directly to the chosen stock exchange.[10] These entities, referred to as "venues," are market makers.[11] Market makers provide liquidity for the public equity markets by acting as the buyer for investors looking to sell or serving as the seller for investors looking to buy.[12] Market makers enable free and ready trading in any publicly traded company. Without market makers, it is unlikely the market could sustain its current trading volume.[13]

Citadel Securities, a major market maker for public securities, paid Robinhood for its order flow.[14] A troubling revelation was that Citadel Securities contributed $2 billion of the total "bailout" of $2.75 billion to Melvin Capital, another hedge fund.[15]

According to written testimony from Melvin Capital founder and Chief Investment Officer Gabriel Plotkin, Melvin Capital had targeted GameStop for what is referred to as a "short sell" as early as 2014.[16]

(Jan. 29, 2021), https://www.washingtonpost.com/business/2021/01/29/robinhood-citadel-gamestop-reddit/ [https://perma.cc/6G3Y-SKU4].

9. *Id.*

10. Alexander, *Payment for Order Flow*, DAYTRADINGZ (July 30, 2022), https://daytradingz.com/payment-for-order-flow/ [https://perma.cc/KP5H-L9CS].

11. Katherine Doherty & Lydia Beyoud, *Why Payment for Order Flow Made Trades Free but Left SEC Skeptical*, BLOOMBERG (Dec. 17, 2022), https://www.bloomberg.com/news/articles/2022-07-05/why-sec-s-targeting-stock-payment-for-order-flow-quicktake [https://perma.cc/6UCN-2633].

12. Joshua Kennon, *What Is a Market Maker?*, BALANCE (Apr. 15, 2022), https://www.thebalancemoney.com/what-is-a-market-maker-and-how-do-they-make-money-4053753 [https://perma.cc/5S6T-5W66].

13. *Id.*

14. *Id.*

15. Juliet Chung, *Citadel, Point72 to Invest $2.75 Billion into Melvin Capital Management*, WALL. ST. J. (Jan. 25, 2021), https://www.wsj.com/articles/citadel-point72-to-invest-2-75-billion-into-melvin-capital-management-11611604340 [https://archive.ph/pHtEw].

16. *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 41 (2021) (statement of Gabriel Plotkin, Founder and CIO, Melvin Capital Management).

"Short selling" is a practice where the investor bets that the stock will decrease in value instead of increase.[17] GameStop is the same company that Robinhood restricted trading on further GameStop *purchases*.[18]

The decision to halt trading presented Robinhood as siding with the rich and taking from the poor, contradicting Robinhood's namesake and stated mission of making investing accessible to the masses.[19] Robinhood founder and CEO Vladimir Tenev gave press conferences and even testified before Congress to explain his decision.[20] But the explanation obscurely mentioned needing to meet its capital requirements and having to provide additional capital to protect against default from volatile stocks.[21]

Delving into the stock market's inner workings, this Article examines Tenev's explanation and its implications. Accordingly, this Article reviews "short squeezes" as retail investors performed one on Melvin Capital via Robinhood.[22] Robinhood argued that prohibiting the traders on its platform was necessary to limit the amount of additional collateral that Robinhood would have needed to cover those trades.[23] This Article explores that "necessity." The timing here is significant because when Robinhood placed restrictions on its retail investors, the GameStop share price was on an upward trajectory.[24] Had Robinhood allowed further GameStop share purchases from those trading on its app, there is no telling how high GameStop's share price might have reached. Regarding Robinhood's decision to restrict trading when it did: was that decision a legal requirement, or was it a discretionary business decision intended to mitigate risk and Robinhood's exposure?

This Article proceeds as follows: Part I discusses the evolving trading landscape. It explains how the mix of technology, "no fee" commissions, and social media have changed the equity trading landscape, which all worked together to make a situation like the

17. Douglas M. Branson, *Nibbling at the Edges—Regulation of Short Selling: Policing Fails to Deliver and Restoration of an Uptick Rule*, 65 BUS. LAW. 67, 68 (2009).

18. Leonhardt, *supra* note 1.

19. Robinhood Markets Inc., Amendment No.2 to Prospectus (Form S-1) (Oct. 8, 2021).

20. *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. 6-8 (2021) (statement of Vladimir Tenev, Co-founder and CEO, Robinhood Markets, Inc.).

21. *Id.*

22. Branson, *supra* note 17.

23. Tenev, *supra* note 20.

24. *GameStop Corp. (GME)*, *supra* note 2.

GameStop "short squeeze" an eventuality that, before now, was never something to consider or be concerned about.

Part II discusses hedge funds and how they engage in short selling. This discussion includes which types of investors short sell, and the business decisions and mechanics involved in short selling.

Part III looks at the short sell situation from Robinhood's standpoint and its retail investors' efforts to engage in the practice referred to as a "short squeeze." A short squeeze is an effort to thwart an investor's effort to short sell a stock by running up the stock's price through the heavy purchase of those shares.[25] As mentioned in the introduction, Robinhood made the unpopular decision of halting trading on the GameStop purchases.[26] Robinhood's trading restriction terminated the short squeeze.

Part IV explains in-depth Robinhood's decision to temporarily restrict its retail customers from making further GameStop purchases. Robinhood and its founder Mr. Tenev were held accountable for this action.

Part V examines the actual events that prompted Robinhood to restrict its customers from further share purchases in GameStop. It explains the obscure collateral requirement adherence that Robinhood pointed to as the reason for restricting trades. The Article proceeds to analyze that decision and makes clear that Robinhood's decision to restrict trading was a business one rather than one that was legally required.

Part VI openly questions on whom the risk should lie regarding exposure to meeting collateral requirements. Part VI points out the role that brokers play in exposing themselves and their customers to the risk of defaulting on trades.

Part VII provides an update on the events that have transpired since the GameStop short squeeze that occurred in January of 2021. Part VII also examines the possible long-term implications of this event.

Part VIII explores solutions and attempts to frame the dilemma that the brokerage industry and its regulators are grappling with: an evolving investor landscape that has made investing more accessible and enticing to novice investors who are impacting this space in ways not seen before.

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25. Amber Francis, *How GameStop Enthusiasts Caused a Short Squeeze in the Stock Market*, TEX. A&M U. COLL. OF ARTS & SCIS. (Mar. 15, 2021), https://liberalarts.tamu.edu/blog/2021/03/15/how-gamestop-enthusiasts-caused-a-short-squeeze-in-the-stock-market/.

26. Leonhardt, *supra* note 1.

How should regulators balance the opportunities that come with access to the public markets against the risk that these investors will confront? Such risks are accentuated by today's readily accessible, no-fee, "game-like" trading environment.

Part IX concludes by summarizing the competing tensions here between investor protection and investor opportunity. Part IX summarizes those trade-offs and reiterates that retail investors will have to appreciate the risk reward component here. With more protection comes more limitations. Part IX in concluding makes sure to underscore this point.

I. THE EVOLVING DAY TRADING LANDSCAPE

Historically, trading in publicly traded companies was the exclusive province of the wealthy and privileged.[27] Access to the stock market was limited to those with the financial means, and either access to a financial advisor or the requisite sophistication to navigate the stock market's complicated labyrinth.[28] Going back to 1952, only 6.5 million Americans owned stock in publicly traded companies (about 4.2 percent of the U.S. population).[29] By 1990, that number increased to 51 million Americans, roughly 20 percent of the U.S. population at the time owning shares in publicly traded companies; a 376 percent increase over this 38 year period.[30] At the Writing of this article, some 58 percent of the U.S. population have ownership in publicly traded companies.[31] Increased access to the markets has resulted in the growing participation in owning publicly traded companies.

27. Inyoung Hwang, *A Brief History of the Stock Market*, SOFI: LEARN (Jan. 8, 2021), https://www.sofi.com/learn/content/history-of-the-stock-market/ [https://perma.cc/CZ7K-XUPS].

28. *Id.*

29. *Stocks Then and Now: The 1950s and 1970s*, INVESTOPEDIA (Jan. 26, 2021), https://www.investopedia.com/articles/stocks/09/stocks-1950s-1970s.asp [https://perma.cc/6TT4-K2CN].

30. *Id.*

31. Lydia Saad & Jeffrey M. Jones, *What Percentage of Americans Own Stock?*, GALLUP (May 12, 2022), https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx [https://perma.cc/M9WX-3L9K].

A. ONLINE TRADING

In the near past, buying and selling shares of stock was not a small undertaking.[32] Broker fees and commissions were considerable. Going back to the early 1950s, brokers charged $5 and 1 percent of the amount traded to execute trades on shares priced below $10.[33] In 1985, according to a veteran broker active in the space during that time, the average cost to buy or sell was $45 but could "climb much into the hundreds or thousands depending on the size of the order."[34]

As recent as 1992,[35] however, any individual with a computer and access to the internet could participate in the markets through any number of online brokers such as TD Ameritrade, Fidelity Investments, E-Trade, and Merrill Edge.[36] With modern technology, the common person could easily buy and sell stock and at minimal cost.[37] When the online brokerage concerns began to proliferate, retail investors could execute trades for as little as $7 a trade.[38] But these costs would be pushed even lower. Trading with no fees is better than low-cost trading. Robinhood operates on this principle through its online brokerage trading platform. Not only does Robinhood offer free execution of buy and sell orders, but it also allows the user to trade through an application on their cell phone.[39]

The convenience of unhindered access to one's trading account has naturally led to users monitoring their portfolios more frequently. This increased monitoring may produce riskier or more volatile trading patterns as users have 24-hour access to markets.

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32. *Stocks Then and Now*, *supra* note 29.

33. *See* Charles M. Jones, *A Century of Stock Market Liquidity and Trading Costs*, (manuscript at 34) (May 22, 2002), https://ssrn.com/abstract=313681.

34. Rob Wile, *Back in the Day, Brokers Got Away With Murder In Trading Commissions*, BUS. INSIDER (Mar. 31, 2014), https://www.businessinsider.com/historical-trading-commissions-2014-3 [https://perma.cc/9U36-R3EA].

35. E-Trade pioneered online brokerage when it launched in 1992. *See* Jennifer Wu, Michael Siegel & Joshua Manion, *Online Trading: An Internet Revolution* 3 (Sloan CISL Working Paper No. 4104, 1992).

36. Rebecca Lake, *Trading Fees: What Do Brokers Charge to Trade?*, SMARTASSET (Sept. 28, 2022), https://smartasset.com/financial-advisor/trading-fees [https://perma.cc/2GZR-JJP7].

37. *Id.*

38. Wile, *supra* note 34.

39. Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes with Devastating Results*, N.Y. TIMES (Sept. 25, 2021), https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html [https://archive.ph/H6gBY].

Unlike its online trading predecessors, the Robinhood platform was designed with the same dopamine-producing features of social media that trigger addiction or dependency.[40] For example, the app's early iterations featured confetti every time a Robinhood customer initiated a buy or sell order.[41]

Easy access to trading and no-fee commissions enticed younger, less experienced investors to trade through Robinhood's app. Younger investors are typically less risk averse.[42] On average, they have a lower net worth and less investing experience and knowledge.[43] Concerning GameStop, this type of investor would change the landscape of market activity and volatility.

B. Payment for Order Flow

The underpinnings for the no-fee trading model and the feature that makes such trades possible is the phenomenon of PFOF. Notably, in 2020, venues paid $2.75 billion to the 10 leading retail brokerages.[44] "TD Ameritrade and Robinhood made the most money by selling order flow to venues like Citadel Securities, Global Execution Brokers, and Virtu Americas."[45] Further, that number of $2.75 billion paid to brokerages in 2020 grew to $3.62 billion in 2021.[46]

These venues paid Robinhood a total of $687 million for Robinhood to direct their customer orders to them in 2020 and a total of $974 million in 2021.[47] Regarding these payments, Robinhood was second only to TD Ameritrade, which received $1.15 billion in order flow payments in 2020

40. *Id.*
41. *Id.*
42. Ethan Wolff-Mann, *Young Investors Have a Huge Stomach for Risk Right Now, Data Suggests*, YAHOO FIN. (Aug. 19, 2020), https://www.yahoo.com/video/young-investors-have-a-huge-stomach-for-risk-right-now-data-suggests-194739891.html [https://perma.cc/8EXB-CGM7].
43. *Id.*; Robert Farrington, *Average Net Worth of Millennials by Age*, COLL. INV. (Dec. 22, 2022), https://thecollegeinvestor.com/14611/average-net-worth-millennials/ [https://archive.ph/9RALl]; *see also* Robin Powell, *Do We Become Better Investors as We Age?*, TEBI (Mar. 23, 2021), https://www.evidenceinvestor.com/do-older-investors-earn-higher-returns/ [https://perma.cc/Q3XD-7HF5].
44. Namely: TD Ameritrade, Robinhood, E*Trade, Charles Schwab, Fidelity, Webull, TradeStation, Ally Invest, Bank of America, and Wells Fargo. *Id.*
45. *Id.*
46. *Id.*
47. *Id.*

and $1.42 billion in order flow payments in 2021.[48] Citadel Securities has paid the most for order flow; out of the $2.75 billion that the top nine venues paid for order flow in 2020, Citadel paid $1.12 billion—some 40 percent.[49] Citadel's share has stayed consistent as in 2021 where the top nine venues paid $3.62 billion for brokerage overflow—Citadel paid $1.42 billion—some 39 percent.[50]

Accordingly, PFOF is the mechanism that allows customers that trade through Robinhood and other platforms to offer no-fee trading to its customers.[51] These venues, in turn, profit by executing these customer orders off the "spread."[52] The spread is the difference between the price the venue pays to purchase the stock from the customer (the bid price), and the price for which it sells the stock to a buyer (the ask price).[53] The spread on any one trade will be pennies or fractions of pennies.[54] But when you multiply that by trade volume, these venues make billions off of executing customer stock buy and sell orders.[55]

Regulators, legislators, and pundits alike have criticized the PFOF practice, as these critics believe that the "no-fee" trading model encourages riskier trading behavior by investors.[56] The argument follows that where the customer incurs no fee for her buy or sell decision, she uses less discretion and buys and sells with more frequency.[57] Instead of the traditional "buy and hold" strategy, which on average proves to be the most profitable trading pattern for most investors in the long run, being reactive to the market's daily fluctuations results in buying and selling shares with far too much frequency.

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48. *Id.*
49. *Id.*
50. *Id.*
51. Alexander, *supra* note 10.
52. Doherty & Beyoud, *supra* note 11.
53. *Id.*
54. Alexander, *supra* note 10.
55. Doherty & Beyoud, *supra* note 11.
56. Wayne Duggan, *Could the SEC End Payment for Order Flow?*, FORBES ADVISOR (Aug. 22, 2022), https://www.forbes.com/advisor/investing/payment-for-order-flow/ [https://perma.cc/XBW7-BE75]; *see also* Steven Goldberg, *Commission-Free Trades: A Bad Deal for Investors*, KIPLINGER (Oct. 11, 2019), https://www.kiplinger.com/article/investing/t052-c007-s001-commission-free-trades-a-bad-deal-for-investors.html [https://perma.cc/W7NY-FS85].
57. Goldberg, *supra* note 56.

Additionally, pundits have criticized the brokers that operate under the no-fee commission model.[58] They argue that the no-fee commission model creates an incentive for brokers to encourage their customers to engage in more trading. As the customer makes more trades, more order flow is generated by those trades and the brokers receive higher revenue from market makers in exchange for their direction of order flow to these market makers.[59]

To that effect, Robinhood has been accused of incentivizing increased customer orders by gamifying its trading app.[60] For example, Robinhood created an assortment of game-like features to its trading app. that incentivizes and encourages its customers to trade more frequently.[61] Robinhood has defended this practice as during the Financial Services Committee Hearings in February 2021, when Committee Members questioned Mr. Tenev about it, he insisted that the gamification features on the app were market-driven and that Robinhood was merely giving the customers what they wanted.[62]

The second PFOF criticism is that brokers, instead of seeking the best execution price for their customers, the brokers instead direct order flow to the venue that will pay the most for that order flow. Such practice contravenes the Financial Industry Regulatory Authority (FINRA) which is the government authorized not-for-profit organization that oversees U.S. broker-dealers.[63] FINRA requires that brokers seek the best execution price for their customers.[64] For example, FINRA fined Robinhood $1.25 million for:

> [B]est execution violations related to its customers' equity orders and related supervisory failures that spanned from October 2016 to November 2017. As part of the settlement, Robinhood also agreed to retain an independent consultant to conduct a comprehensive review of the firm's systems and procedures related to best execution. FINRA

58. Duggan, *supra* note 56; *see also* Steven Goldberg, *Commission-Free Trades: A Bad Deal for Investors*, KIPLINGER (Oct. 11, 2019), https://www.kiplinger.com/article/investing/t052-c007-s001-commission-free-trades-a-bad-deal-for-investors.html [https://perma.cc/W7NY-FS85].

59. Duggan, *supra* note 56.

60. *Id.*

61. *Id.*

62. Tenev, *supra* note 20.

63. *See What We Do*, FINRA, https://www.finra.org/about/what-we-do [https://perma.cc/2N7G-CZ9Z].

64. FINRA Rule 5310, available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/5310 [https://perma.cc/4PHA-L6S9].

> found that for more than a year, Robinhood which offers its customers the ability to trade in equity securities without being charged commissions, routed its customers' non-directed equity orders to four broker-dealers, all of which paid Robinhood for that order flow.[65]

Upon closer examination, it appears FINRA fined Robinhood because its *process* for directing its customer's trades was deficient. FINRA criticized Robinhood because the *manner* in which Robinhood was directing trades was not in accordance with FINRA's rules.[66] What FINRA found most troublesome was that Robinhood had a closed universe of potential destinations to which order flow would be directed, and coincidentally, all of those destinations were venues that paid Robinhood for its order flow.[67] The news release did not conclude that Robinhood failed to find the best execution for its customers however, but merely that Robinhood was not engaging in the type of conduct that FINRA outlines as practices that leads to the best execution for customers.[68]

PFOF critics have called for an elimination of the practice.[69] A prominent and outspoken critic of this practice is presiding SEC Chairman Gary Gensler. Mr. Gensler believes that customers *must* be getting worse pricing on their stock trades because of the practice.[70] As discussed earlier, the suspicion is that greater payments to brokers must be offset by less favorable execution prices.[71] But there is evidence contrary to this assertion.

In a working paper released in August 2022, five finance professors rebutted the belief that the practice of brokers directing orders to venues in exchange for order flow payments resulted in poorer execution prices for customers.[72] The finance professors conducted the study by analyzing

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65. Michelle Ong & Mike Rote, *FINRA Fines Robinhood Financial, LLC $1.25 Million for Best Execution Violations*, FINRA (Dec. 19, 2019), https://www.finra.org/media-center/newsreleases/2019/finra-fines-robinhood-financial-llc-125-million-best-execution [https://perma.cc/4T62-22E2].

66. *See id.*

67. *Id.*

68. Ong & Rote, *supra* note 65.

69. Bill Alpert, *Payment for Order Flow Worries the SEC. Perhaps It Shouldn't, Study Indicates*, BARRON'S (Aug. 29, 2022), https://www.barrons.com/articles/payment-for-order-flow-sec-51661280732?siteid=yhoof2 [https://archive.ph/vb86u].

70. *Id.*

71. *See id.*

72. *Id.*

85,000 stock trades that the professors made through five leading retail brokers.[73] The professors found that they got significantly different pricing through different brokers for identical orders to buy or sell at the current market price.[74] Their best pricing, however, "came from a broker that takes payment for order flow, namely TD Ameritrade which, as discussed earlier, received the most in order flow payments in 2020 at $1.15 billion and in 2021 of $1.42 billion."[75]

The professors' study noted that Fidelity, which takes no order flow payments, got worse prices on the professors' trades than TD Ameritrade.[76] Furthermore, its prices were no better than those from Morgan Stanley's E*TRADE unit which takes order flow payments.[77] Robinhood, which used revenue from order flow to subsidize the industry's first commission-free trading, delivered middle-of-the-pack pricing.[78] The professors concluded that there was no relationship between paid order flow and price execution.[79]

C. Social Media & WallStreetBets

Statistically, if you are 35 or older, you are likely to have a Facebook account which you may check at least once a day. If you are under 35, more than likely you have moved to more progressive platforms such as Instagram, TikTok, or Twitter. The underlying and recurring theme for each of these platforms is that where people once moved in isolation or as individuals, they can—and now do—move in groups. With the proliferation of communication means, one's power gets multiplied exponentially. Coupling this proliferation of easy access to trading with the ability for many to operate in concert has impacted the financial markets in novel ways.

The final piece to this online trading puzzle is the proliferation of day trading subreddits–chat rooms where investors convene to discuss investing. WallStreetBets was a subreddit founded by Jaime Rogozinski.[80] This online chat room provided the forum where a critical

73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. Akane Otani, *WallStreetBets Founder Reckons with Legacy Amid Stock-Market Frenzy*, WALL ST. J. (Jan. 28, 2021), https://www.wsj.com/articles/wallstreetbets-

mass of investors could work collectively.[81] By working in concert, these individual investors were able to leverage their buying power exponentially. This dynamic would prove to be significant and fatal to at least one hedge fund, which found itself entangled in a short sell play that ended up being opposed by a collective group of retail investors who banded together and used their aggregate buying power to disrupt. Such a move was perhaps not unlike the merry men in the folklore that bears the same namesake of one of the parties to this tale—Robinhood.[82]

II. HEDGE FUNDS

When an investor sells a stock "short," the investor is betting that a company's share price will decrease instead of increase.[83] Investing with the expectation that a company's share price will rise is the typical approach, as share prices tend to increase over time.[84] But that is not always the case. There are those companies that fall out of favor for various reasons. For example, a company's business model may become antiquated without the company showing adequate indications of pivoting or evolving to stay relevant and adjust to market demand.

An investor can profit off of the demise of a business if the company's stock happens to be overpriced and the investor executes his trades properly and times the market right.[85] In short selling, an investor targets a company whose stock price is inflated and not a true reflection of its actual value.[86] If the investor is savvy enough and is willing to take

founder-reckons-with-legacy-amid-memes-loss-porn-and-online-threats-11611829800 [https://archive.ph/ImEQu].

81. Matthew Goldstein & Kate Kelly, *Melvin Capital, Hedge Fund Torpedoed by the GameStop Frenzy, is Shutting Down*, N.Y. TIMES (May 18, 2022), https://www.nytimes.com/2022/05/18/business/melvin-capital-gamestop-short.html [https://archive.ph/1iISU].

82. *Id.*

83. Chad Langager, *Short Selling: How Long Does a Short Seller Have Before Covering*, INVESTOPEDIA (June 4, 2021), https://www.investopedia.com/ask/answers/05/shortsaleclosed.asp [https://perma.cc/73HF-NSPR].

84. Adam Hayes, *Long Position: Definition, Types, Example, Pros and Cons*, INVESTOPEDIA (Oct. 6, 2021), https://www.investopedia.com/terms/l/long.asp [https://perma.cc/MYC6-7KY4].

85. Alan Farley, *Rules and Strategies for Profitable Short Selling,* INVESTOPEDIA (Sept. 29, 2022), https://www.investopedia.com/articles/active-trading/031815/rules-and-strategies-profitable-short-selling.asp [https://perma.cc/84AR-UZ3J].

86. *Id.*

on the risk to try and profit off what the investor believes to be a company with an inflated stock price, the investor will engage in what's referred to as a short sell.

In a short sell, the investor sells first by borrowing the targeted stock from a broker. Again, the premise here is that the stock is overpriced and the investor will profit when the share price eventually falls. The investor then sells those shares on the open market at what the investor hopes is the inflated price. The investor will then wait for the price to drop.[87] Once the price drops, the investor will buy the shares back from the open market.[88] He will then return those borrowed shares to the broker, and he will pocket the difference between the sell price and purchase price as profit.[89]

Short selling is risky. First, there is the general risk that the investor is incorrect about the targeted company.[90] Instead of the company's stock falling in price as the investor predicts, the stock price rises. The investor must be savvy and insightful about his assessment. The investor cannot operate in a vacuum when making a short sell play.

Metrics such as the targeted company's projected profitability, business model, and market competitors are all important factors. Additionally, the investor must also be able to consider the market as a whole.[91] In the case of GameStop, part of the market as a whole included a band of retail investors that disrupted the GameStop short sell and sent the market into a period of "recalibration."[92]

Second, the investor may be right about the targeted company's share price decreasing in value, but there is a timing component as well. The short selling investor has borrowed the shares; those shares must be returned to the broker, as other investors actually own those shares.[93]

Once the investor borrows those shares from the broker, the short sell play is now on the clock. If the borrowing window closes and the investor must return the shares before the price falls, then the short sell will be unsuccessful.[94]

87. *Id.*

88. *Id.*

89. *Id.*

90. Brian Beers, *How an Investor Can Make Money Short Selling Stocks*, INVESTOPEDIA (Mar. 13, 2022), https://www.investopedia.com/ask/answers/how-does-one-make-money-short-selling/ [https://perma.cc/GL9H-NEJW].

91. *Id.*

92. *See, e.g.*, Goldstein & Kelly, *supra* note 81.

93. Langager, *supra* note 83.

94. *Id.*

The third scenario occurs when the targeted company's share price rises instead of falls. This third scenario is what makes short selling so perilous and why only those that have the sophistication to execute a short sell properly—and the ability to absorb the loss if a targeted company increases in value instead of decreases—should engage in short selling.[95]

When the price of a shorted stock increases, the investor's potential losses are limitless because the higher the stock price rises, the more the investor will have to pay to buy back the shares from the market and there is no limit to how high a share price can rise.[96] When a targeted company's share price rises, the investor finds himself in a precarious short selling test of wills. When that stock price rises instead of falling as hoped for, the investor has to make some decisions.

First, the investor could immediately accept that he may have miscalculated the value of the stock. In that event, the investor may buy back the shares from the open market promptly, thus either mitigating a potentially larger loss or avoiding losses altogether.[97] The decision to get out of the short sell quickly is akin to a gambler knowing when to fold.

Second, the investor could keep his position in the targeted company's shares and hope that the share price will eventually drop. In that scenario, the investor has decided to engage in a test of wills with the market and the targeted company. The investor hopes the share price will come back down and eventually fall below the price for which the investor initially sold those borrowed shares to the market.

Alternatively, the shares could continue to rise—this is the nightmare scenario mentioned earlier. Recall, the investor is on the clock as these are borrowed shares and must be returned at some point.[98] What ultimately happens in this scenario depends on the relationship between the investor who borrowed the shares and the broker from whom the shares were borrowed.[99] For example, the investor in question could be a hedge fund, and therefore given more latitude. If the broker is comfortable with the hedge fund's ability to cover the mounting losses that the hedge fund is accruing, the broker may extend the time until the hedge fund is

95. Beers, *supra* note 90.
96. *Id.*
97. Langager, *supra* note 83.
98. *Id.*
99. *Id.*

required to return the borrowed shares and will allow the shares to remain outstanding instead.[100]

III. Selecting a Short Sell Target

> Specific to GameStop, we had a research-supported view well before the recent events. In fact, we had been short GameStop since Melvin's inception six years earlier because we believed and still that its business model–selling new and used video games in physical stores–is being overtaken in digital downloads through the internet. And that trend only accelerated in 2020, when because of the pandemic, people were downloading video games at home. As a result, the gaming industry had its best year ever. But GameStop had significant losses.[101]

As discussed earlier, when an investor believes that a company's stock price is overvalued, the investor can short the stock.[102] As stated in Mr. Plotkin's testimony, Melvin Capital believed that GameStop was a company whose stock was overpriced, citing what Melvin Capital believed to be an outdated business model; that of selling video games in video stores.[103]

To that point, in reviewing GameStop's financials dating back to fiscal year ending 2017, GameStop posted the following in net income or net losses during those time periods:

FYE – (in millions)[104]

	2021	2020	2019	2018	2017
NI/(Loss)	($381.3)	($215.3)	($470.9)	($673)	$34.7

Though a company's net income or net loss is just one financial metric, at the very least, it is clear that the last time GameStop had posted a profit within this time frame was 2017, further supporting the notion that GameStop was a business model that was once favored but started reporting net losses beginning fiscal year ending 2018.

100. *Id.*
101. Plotkin, *supra* note 16.
102. Langager, *supra* note 83.
103. Plotkin, *supra* note 16.
104. GameStop Corp., Annual Report (Form 10-K) (Jan. 29, 2022); *see also* GameStop Corp., Annual Report (Form 10-K) (Jan. 30, 2021); GameStop Corp., Annual Report (Form 10-K) (Feb. 1, 2020).

FYE – (in millions)[105]

	2016	2015	2014	2013	2012
NI/(Loss)	$353.2	$402.8	$393.1	$354.2	($269.8)

Further supporting the finding that GameStop's business model was once favored but may have become antiquated over time is its historical net income/net loss dating back to 2012. Except for 2012, fiscal years 2013–2016 show that the video game provider was doing well and showing steady, healthy profits.[106] Again, this was prior to the market evolving to a predominantly online/download model. According to Mr. Plotkin's testimony, Melvin Capital had GameStop in its sights for a short sell since around 2015, which is right around the time GameStop's net income started to decline, until the company began to show consistent losses from 2018 to present.[107] Additionally, Melvin Capital's decision to target GameStop for a short sell appeared to be supported by quantifiable metrics. But Melvin Capital failed to see the lurking band of Robinhood traders.

IV. ROBINHOOD PLACES TRADE RESTRICTIONS ON ITS CUSTOMERS

On Thursday, January 28, 2021, Robinhood placed limits on client trading sharply restricting the number of shares an individual could buy of GameStop shares.[108] Robinhood's decision to restrict further GameStop purchases effectively short-circuited the "short squeeze" retail traders were exacting upon Melvin Capital and any other hedge funds or investors who were short selling GameStop shares. Robinhood was heavily criticized for this decision.[109] Politicians on opposite sides of the aisle, for a brief moment in time, were united in their ire at Robinhood for its decision.[110] In the immediate aftermath of Robinhood's decision, U.S.

105. GameStop Corp., Annual Report (Form 10-K) (Jan. 28, 2017).
106. GameStop Corp., Annual Report (Form 10-K) (Jan. 28, 2017).
107. *Id.*; Plotkin, *supra* note 16.
108. Leonhardt, *supra* note 1.
109. Egan, *supra* note 7.
110. Tucker Higgins, *Lawmakers from AOC to Ted Cruz Are Bashing Robinhood Over Its GameStop Trading Freeze*, CNBC (Jan. 28, 2021), https://www.cnbc.com/2021/01/28/gamestop-cruz-ocasio-cortez-blast-robinhood-over-trade-freeze.html [https://perma.cc/R93J-K32P].

Representative for New York's 14th Congressional District Alexandria Ocasio-Cortez tweeted:

This is unacceptable. We now need to know more about Robinhood's decision to block retail investors from purchasing stock while hedge funds are freely able to trade the stock as they see fit. As a member of the Financial Services [Committee], I'd support a hearing if necessary.[111]

In a rare moment of unity between these opposing party members, U.S. Senator Ted Cruz responded to AOC's tweet: "I agree."[112]

Shortly after Robinhood's restricted trading fiasco, the House of Representatives Committee on Financial Services commenced a virtual hearing with presiding Chair Maxine Waters serving as moderator.[113] The Committee held the meeting on February 18, 2021.[114] The hearing spanned some five and a half hours.[115] In rapid-fire succession, each committee member targeted their witness and levied their questions.[116] The testifying witnesses were those individuals who headed the entities that had substantive involvement with the GameStop short sell.[117] In mid-2019, Keith Gill began posting on his social media accounts his theories about why GameStop was undervalued.[118] His first post on the WallStreetBets subreddit showed a screenshot of his $53,566.04 purchase of GameStop call options.[119]

Depending on the representative, questioning ranged from harsh to conciliatory.[120] Mr. Tenev fielded the bulk of the questions.[121] And it was

111. @AOC, TWITTER (Jan. 28, 2021, 10:36 AM), https://twitter.com/aoc/status/1354830697459032066?lang=en [https://archive.ph/rL7HU].

112. Higgins, *supra* note 110.

113. U.S. House Comm. on Fin. Servs., *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, YOUTUBE (Mar. 17, 2021), https://www.youtube.com/watch?v=imRzHXRq80I.

114. *Id.*

115. *Id.*

116. *Id.*

117. Mr. Plotkin, founder and Chief Investment Officer of Melvin Capital Management, Vladimir Tenev, Co-Founder and Chief Executive Officer of Robinhood, Inc., Ken Griffin, Chief Executive Officer of Citadel Securities, and Keith Gill, a day trader who gained notoriety for betting big on GameStop and cashing out for millions were the main witnesses who were called to testify. *Id.*

118. *See* U.S. House Comm. on Fin. Servs., *supra* note 113.

119. u/DeepFuckingValue, REDDIT: WALLSTREETBETS (Sept. 8, 2019, 1:12 PM), https://www.reddit.com/r/wallstreetbets/comments/d1g7x0/hey_burry_thanks_a_lot_for_jacking_up_my_cost/ [https://perma.cc/L3G7-6DHB].

120. *Id.*

121. *Id.*

clear from the line of questioning that many Committee members felt that something was amiss regarding how Robinhood abruptly halted trading. Mr. Tenev opined that the GameStop short squeeze was a rare event.[122] And, though unfortunate, Robinhood had to restrict trading in order to mitigate risk and be able to meet its collateral obligation with the Depository Trust & Clearing Corporation (DTCC).[123] Mr. Tenev maintained that this was the sole reason for Robinhood's decision to halt trading.[124]

Mr. Tenev explained that the GameStop short squeeze was a "one in 35 million event[,]" that only 2 percent of Robinhood's customers borrow on margin, and that Robinhood's customers enjoyed "$35 billion in realized and unrealized gains."[125]

Mr. Tenev's answers ranged in clarity as some came off as evasive in response to arguably the tougher questions. For example, when asked what the principal balance was on the $35 billion in gain, Mr. Tenev either could not or would not give an answer.[126] Answering that question would have given a much more accurate picture of whether Robinhood's customers were actually building true wealth through equity trading on Robinhood's platform or not. Other Committee members questioned whether Robinhood could and should do more to inform and educate their clients.[127] Mr. Tenev stoically explained that Robinhood strictly adhered to all regulatory and compliance requirements.[128]

The final fallout came from Robinhood's retail customers when a number of them filed a class action lawsuit.[129] Among other things, the suit alleged Robinhood "purposefully, willfully, and knowingly remov[ed] the stock 'GME' from its trading platform in the midst of an unprecedented stock rise thereby depriv[ing] retail investors of the ability to invest in the open-market and manipulating the open market."[130]

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122. *Id.*

123. U.S. House Committee on Financial Services, *supra* note 113. The DTCC will be discussed in depth in the following Section V.

124. *See id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. Leonhardt, *supra* note 1.

130. Complaint at 1, Nelson v. Robinhood Fin., No. 21-cv-777 (S.D.N.Y. Jan. 28, 2021).

Adding further fuel to the fire, Citadel Securities and Point72 Asset Management placed a combined $2.75 billion with Melvin Capital. Some viewed this placement as a bailout to shore up Melvin Capital's losses due to their failed GameStop short sell.[131] The agitating point here was the relationship between Citadel Securities and Robinhood: Citadel Securities pays Robinhood for its order flow.[132]

In the Committee hearings, when questioned about the $2 billion placement with Melvin Capital, Citadel CEO Ken Griffin insisted that investing in Melvin Capital was simply a sound investment decision.[133] It is noted that Citadel placed this money with Melvin Capital on January 25, 2021, just days prior to Robinhood's decision to restrict trading on GameStop.[134] Coincidentally, Citadel's buy-in with Melvin Capital occurred right at the time Melvin Capital was reversing its short position in GameStop and losing billions to cover the position.[135] When Mr. Griffin was asked whether Citadel Securities had ever placed their money with Melvin Capital prior to this time, Mr. Griffin acknowledged that they had not.[136]

Finally, Robinhood's retail customers had strong reactions to Robinhood restricting their ability to make certain trades. A handful took the extreme measure of showing up at Robinhood's headquarters in Menlo Park, California to voice their concerns directly to Robinhood personnel:

> A Menlo Park Police spokesperson said the incidents include as many as 15 people protesting outside of the office, and a male suspect throwing a t-shirt at a security guard. Another suspect sawed into a sculpture on Robinhood's property. A third man threw animal feces at the front door, according to police.[137]

Their anger was understandable and I doubt if the explanation they would later learn did anything to placate.

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131. Chung, *supra* note 15.
132. U.S. House Comm. on Fin. Servs., *supra* note 113.
133. *Id.*
134. *Id.*
135. Chung, *supra* note 15.
136. *Id.*
137. Yasmin Khorram & Kate Rooney, *Angry Customers Show Up at Robinhood's Headquarters in the Wake of GameStop Trading Chaos*, CNBC: FIN. (Feb. 11, 2021), https://www.cnbc.com/2021/02/11/angry-customers-show-up-at-robinhoods-headquarters-in-the-wake-of-gamestop-chaos.html [https://perma.cc/M8GS-BFLC].

V. CLEARING HOUSES AND COLLATERAL REQUIREMENTS

Publicly, Robinhood claimed it was forced to restrict further trading on GameStop share purchases.[138] When an investor decides to buy or sell a security, the investor puts the order in with his broker—Robinhood, TD Ameritrade, or whomever.[139] Next, the broker places the order with a national exchange–usually the New York Stock Exchange (NYSE) or the National Association of Securities Dealers Automated Quotations (NASDAQ).[140] Those exchanges match orders of buyers and sellers.[141]

The next part of the process involves a less familiar entity called the DTCC.[142] The DTCC is the clearing house for all the stock buys and sells transacted on these national exchanges.[143] It is the DTCC's involvement that ensures that the markets stay liquid and that all buy and sell orders get executed.[144] More specifically, "[t]he clearing house promises to make good on all trades that happen regardless of what happens to an individual broker. The DTCC is responsible for transferring ownership of the stock from the seller's broker to the buyer's broker–and vice versa for the cash involved."[145]

Under this process, the time period from when an investor places a trade order to the time the trade is completed is 2 days.[146] An order is completed when the seller receives the cash and the buyer, through their respective brokers, takes ownership of the shares.[147] The risk that comes with this 2 day float is that the stock's market price could rise or fall appreciably during that 2 day interim period between the trade date and the settlement date. The risk of significant price fluctuations is especially great for volatile stocks, such as those that have been targeted for a short sell and where the short sell is being disrupted by a short squeeze.

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138. U.S. House Comm. on Fin. Servs., *supra* note 113.

139. *Understanding Order Execution,* INVESTOPEDIA (July 5, 2022), https://www.investopedia.com/articles/01/022801.asp [https://perma.cc/39ZK-Y2RS].

140. *Id.*

141. *Id.*

142. Nicholas Jasinski, *Why Did Robinhood Stop GameStop Trading? Everything to Know*, BARRON'S (Jan. 29, 2021), https://www.barrons.com/articles/why-did-robinhood-stop-gamestop-trading-51611967696 [https://perma.cc/3JBC-88H8].

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

To account for this risk in price fluctuation, the DTCC requires brokers to put up collateral for the trades to ensure they have the cash available to complete the transaction.[148] Brokers placing buy orders must put up cash for collateral until the transaction is complete.[149] By the same token, those brokers placing sell orders must put the shares being sold up for collateral.[150] Moreover, "[t]he DTCC's collateral requirements for brokers are calculated by a much more complex formula, based on the specific shares' notional value, volatility, and other variables."[151] "For a relatively risk-free transaction in liquid, less volatile stocks like, say Apple, or Microsoft–that collateral requirement could be around the order of 10 percent of the transaction value."[152] For a stock like GameStop—trading during the week where the day trader's short squeeze was at a fever pitch and putting the stock's volatility off the charts— "the DTCC's formula might spit out a collateral requirement several times higher than that because the DTCC is taking on greater risk."[153] This is so because the DTCC would be required to settle a trade that could be of considerably less value on the settlement date than the stock's value on the trade date.[154] The collateral requirement buffers that risk.

A. Robinhood Traders – The Run–up on GameStop

Given the DTCC's collateral requirement, Robinhood had to cover GameStop purchases on behalf of its customers.[155] The DTCC required Robinhood to raise an additional $3 billion to cover trades in GameStop and other stocks during those periods of intense volatility.[156] At the time, Robinhood did not have that cash on hand, so it was forced to raise additional capital from venture capitalists and others to satisfy the collateral requirements needed to cover the GameStop trades.[157]

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148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*
154. *Id.*
155. John Csiszar, *What Happens When a Brokerage Firm Doesn't Have Enough Capital to Cover Trades?*, GoBankingRates (July 28, 2021), https://www.gobankingrates.com/investing/strategy/economy-explained-brokerage-house-not-enough-liquid-capital-cover-trades/ [https://perma.cc/YMS5-V5DU].
156. *Id.*
157. *Id.*

Adding to the exposure, a significant amount of Robinhood customers were buying these GameStop shares on margin.[158] Buying on margin occurs where the broker lends money to the retail investor that the investor can use to purchase stock.[159] Generally speaking, brokers will allow customers to borrow up to 100 percent of the amount the customer has on deposit. For example, if a customer has $2,000 on deposit with the broker, the customer can buy up to $4,000 worth of stock. The difference between the customer deposit amount and the amount the broker lends is the "margin."[160] In this example, the margin is $2,000.

B. Robinhood's Decision to Restrict Trading Was Discretionary

Robinhood has repeatedly defended its decision to restrict trading as necessary to avoid increased exposure caused by heavy trading in a volatile stock, particularly, GameStop.[161] However, questions remain surrounding Robinhood's explanation. Robinhood was not legally required to restrict further purchases on GameStop shares; rather, Robinhood acted in its own business interest. Moreover, Robinhood made the decision to restrict trading to protect itself—not necessarily to protect its customers. But it was Robinhood's business model that left it exposed in the first place.

Robinhood's argument for placing trade restrictions were due to their customers taking a long position in GameStop with a significant portion of that position being staked using margin loans that Robinhood provided its customers.[162]

Though granting margin loans to its retail customers is a common practice in the industry,[163] Robinhood was especially liberal with its margin lending practices. By paying a monthly fee of $5, Robinhood customers could get an interest-free loan of up to $1,000 that they could

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158. Stephen Gandel, *Robinhood Offers Loans to Buy Stock – They Were 14 Times More Likely to Default*, CBS NEWS (Feb. 5, 2021), https://www.cbsnews.com/news/robinhood-stock-loans-were-14-times-more-likely-to-default-than-rivals/ [https://perma.cc/K95R-9UK2].

159. *Id.*

160. *Id.*

161. Tenev, *supra* note 20.

162. *Id.*

163. *Best Margin Interest Rates Comparison For 2023*, TOPRATEDFIRMS (Jan. 1, 2023), https://topratedfirms.com/brokers/fees/margin-rates-major-brokerages.aspx [https://archive.ph/oofrX].

use to buy stock.[164] For amounts above $1,000 the customer would have to pay interest on the borrowed funds.[165] For these additional borrowed funds, Robinhood was charging an annual interest rate of 2.5 percent.[166] By comparison, E*TRADE charged 12.5 percent for margin loans and TD Ameritrade charged 13.25 percent for such loans.[167]

Adding to the mix was Robinhood's prevailing customer demographics. In Robinhood's marketing materials and embedded in its business model—with even its namesake supporting this notion—Robinhood touted itself as the brokerage firm that was to widen the net of those who could participate and have access to the public markets.[168] Robinhood's no-fee commission was a major part of its draw. Robinhood therefore attracted younger investors with little to no investing experience. The average age of Robinhood's customers is 31, with the most saturated user-group on the app being between the ages of 27 and 33 with most users being male.[169] More than one in four of these people report that they are investing for the first time.[170]

Studies show that this demographic has a higher propensity to take greater risks and therefore be very aggressive in their investing approach.[171] Additionally, this demographic on average has a net worth of $122,200 and a median net worth of $35,112.[172] This is modest compared to the 50–54 demographic, where the average net worth is $897,663 and the median net worth is $171,360.[173] The point here being that the typical Robinhood investor at that point in their life and career has not spent a whole lot of time amassing wealth, and therefore has little to lose and a lifetime to gain it back in the event that they do suffer big losses. Couple that pro-risk profile with a global pandemic that prompted the government to disseminate stimulus checks to keep the American

164. Gandel, *supra* note 158.

165. *Id.*

166. *Id.*

167. *U.S. Margin Loan Rates Comparison*, INTERACTIVEBROKERS, https://www.interactivebrokers.com/en/trading/lp-margin.php [https://archive.ph/ydpqb].

168. Robinhood Markets Inc., *supra* note 19.

169. Jordan Tuwiner, *51 Robinhood Users & Revenue Statistics (2023)*, BUY BITCOIN WORLDWIDE (Jan. 2, 2023), https://buybitcoinworldwide.com/robinhood-statistics/ [https://archive.ph/6MrN5].

170. *Id.*

171. Wolff-Mann, *supra* note 42.

172. Rosemary Carlson, *Average Net Worth by Age*, SMARTASSET (Feb. 14, 2022), https://smartasset.com/financial-advisor/average-net-worth-by-age.

173. *Id.*

public afloat while the economy stagnated due to the pandemic, and you have the perfect storm of what was to come with GameStop.[174] The argument here being that Robinhood created the culture. They courted the type of investor that had both a high-risk tolerance coupled with a low investor IQ. That investor profile, coupled with the fact that Robinhood made it very easy for their customers to leverage their buying power, is what helped to create the situation where those novice investors could go long on a stock artificially inflated exponentially compared to what the stock was actually worth.

To be fair, at the time Robinhood was formulating its business model, the situation like the one that occurred with GameStop was unprecedented and therefore arguably unforeseeable. At no point in history did a group of retail investors work in concert to use their aggregate buying power to go long on a stock that had been hedge fund targeted for a short sell.[175]

Robinhood's decision to restrict further GameStop purchases was a discretionary one, not one that was made to fulfill any legal or compliance requirement even though the DTCC required Robinhood to put up additional collateral to cover the pending GameStop purchases that Robinhood's customers had placed.[176] No rule nor legal mandate states that a broker *must* restrict their customers from trading in certain stock if the stock becomes volatile or the potential exposure becomes significant. Robinhood's decision to restrict trading was its alone. Despite the discretionary nature of its decision, Robinhood touted the decision as a necessary one.[177]

In the February 18 Committee on Financial Services Hearing, the Committee overlooked the fact that Robinhood's decision to restrict trading was discretionary.[178] Mr. Tenev should have been called to task and should have, at the very least, been asked for his reaction to this. But in the 5 plus hours of question and answer, not one committee member

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174. Jonathan Garber, *GameStop Stock Surge Fueled by Stimulus Checks: Billionaire Gundlach*, FOX BUS. (Jan. 29, 2021), https://www.foxbusiness.com/markets/gamestop-stock-stimulus-checks-gundlach.

175. As Mr. Tenev stated in his testimony, this was a "one in 3.5 million event." Tenev, *supra* note 20.

176. Csiszar, *supra* note 155.

177. *See* Tenev, *supra* note 20.

178. U.S. House Comm. on Fin. Servs., *supra* note 113.

emphasized that Robinhood did not have to suspend trading—it merely chose to.[179]

Alternatively, Robinhood could have allowed the trading to continue to the extent that the customers' account balances would allow. Whatever collateral requirement that the DTCC required for that trading activity, Robinhood could have made whatever efforts were necessary to provide that collateral. A foreseeable outcome is that the stock maintained its value during the 2-day period between the trade date and the settlement date, and the trades were completed without incident. But instead, Robinhood took the route that kept its exposure limited.[180] Consequentially, hedge funds, such as Melvin Capital, benefitted from Robinhood's decision as it prevented GameStop's shares from rising even further, which would then have cost Melvin Capital even more to divest its position in GameStop.[181]

Despite this deserved criticism, Robinhood may have also protected its customers from potentially catastrophic losses. GameStop's inflated price during early 2021 trading was an artificial one being driven primarily by retail investors, most of whom were Robinhood customers who made the concerted decision to buy GameStop shares and drive the price up—simple supply and demand.[182] When a stock price is rising under these circumstances, it is not a question of *if* the price will come back down, but *when*. Getting into a stock is easy, but the question of when to get out of a position is the trickier one, especially where the investment play is a "short squeeze" that involves a company with an arguably antiquated business model.

Here, Robinhood's retail customers were performing a high–wire act, but it wasn't clear how things were going to end. Many of these retail traders didn't have an exit plan.[183] Further, many had no true understanding of how exiting their positions in GameStop profitably was supposed to work.[184] And many may not have had a full appreciation of

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179. *See id.*

180. Tenev, *supra* note 20.

181. *See* Chung, *supra* note 15.

182. Alex Fitzpatrick, *So, Uh, What's Up with GameStop's Stock?*, TIME (Jan. 26, 2021), https://time.com/5933242/gamestop-stock-gme/ [https://archive.ph/ScuQA].

183. Les Nemethy, *GameStop and Silver: Failure in Exit Strategy*, BUDAPEST BUS. J. (Feb. 21, 2021), https://bbj.hu/economy/statistics/analysis/gamestop-and-silver-failure-in-exit-strategy [https://perma.cc/6KTN-6VXL].

184. *See* SPENCER JAKAB, THE REVOLUTION THAT WASN'T: GAMESTOP, REDDIT, AND THE FLEECING OF SMALL INVESTORS 135–145 (2022) (discussing how the WallStreetBets subreddit operated somewhat in concert but by no means did those retail investors move

the precarious financial position that they were now in. So, Robinhood's trading restriction which, essentially amounted to a forced sale, may have helped many of its retail customers avoid significant losses. In turn, although there is a strong argument that Robinhood's decision to restrict trading was to protect itself, the argument also exists that it protected its customers as well.

VI. SHOULD BROKERS HAVE AN OBLIGATION TO PROTECT?

The discussion in the previous section raises the question: Should a broker protect its clients by making the unilateral decision to restrict or limit a customer's ability to trade in certain stocks?

This inquiry exemplifies the pitfalls of margin lending. Where brokers allow their customers to borrow money to make speculative investments, a potential outcome is the one that we saw with GameStop. The margin lending aspect exposes both the investor and the broker, and when that scenario is created, you can see where the broker will be in a position where it must make decisions that may harm the investor, or at the very least, limit the upside that the investor might have realized. Margin lending gives investors both opportunity and exposure at the same time. The opportunity to use that leverage to achieve greater wealth but simultaneously the exposure that can subject the investor's personal assets to seizure and attachment if the broker decides to seize client assets to cover stock selections that have suffered significant losses in value.

The broker is also attached to that opportunity vs exposure dynamic as the broker may have to step in thereby thwarting possible further gains, but at the same time short circuiting potentially greater losses.

Some scholars have suggested that brokers in the United States should adopt some international practices.[185] For example, Dr. Iris H-Y Chiu suggests, "Regulators should consider imposing gatekeeping duties on brokers, targeted at compulsive gambler-investors, perhaps under the framing of vulnerable customers, adopted in the U.K. Vulnerable customers are defined as those particularly susceptible to harm due to

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in a monolithic fashion. Some sold their shares earlier than others. Some refused to sell at all. There was no clear plan for the exit strategy.).

185. *See generally* Iris H-Y Chiu, *Social Disruptions in Securities Markets—What Regulatory Response Do We Need?*, 28 RICH. J.L. & TECH. 46 (2021).

their personal circumstances, which include infirmities, disabilities, and changing life circumstances."[186]

Dr. Chiu further explained that "[f]inancial intermediaries in the UK are strongly encouraged to undertake an assessment of all retail customers to identify vulnerabilities. Similarly, online brokers should assess for vulnerability, even if retail investors are expressly in an *execution only* account arrangement, where investment advice is not provided."[187] In her article, Dr. Chiu acknowledges the competing tensions that could result from limiting a retail investor's investment options.[188] But she notes that those retail investors who fall into this category of "compulsive gamblers" represent a small minority of retail investors in this population.[189] She asserts that for this small population with this acute challenge, some type of protective intervention is warranted.[190]

Dr. Chiu's position is appreciated as the approach is one that is limited in scope and tailored to reach the most vulnerable while leaving the investor population as a whole untethered from unnecessary restriction.

The challenge here is that wherever or however regulators draw that line, invariably there will be a subset of disgruntled investors that will cry foul and argue that they have been disenfranchised as a result of not being able to access fully all the possible investment options made available to others. But by the same token, if and when that same investor is harmed as a result of not managing properly those same investment options made available to them, then they may claim that they should never have been given that type of latitude in the first place.

Is there really a problem here in need of a fix? A group of "rogue" retail investors banded together and worked in concert to drive up a flailing company that had been hedge fund targeted for a short sell.[191] In the process, drove up that share price to a point where the hedge fund ended up losing billions on the play.[192] And in the course of that short squeeze, the investors in question are on the less experienced side and are heavily leveraged through one broker who stands to lose billions if

186. *Id.* at 82.
187. *Id.*
188. *See generally id.*
189. *Id.* at 81–82.
190. *Id.*
191. Fitzpatrick, *supra* note 182.
192. Goldstein & Kelly, *supra* note 81.

protective action is not taken.[193] The question is, will short squeezes become more commonplace, or was this a rare and isolated event not likely to occur again? Answering this question helps to give a more thoughtful discussion about an appropriate approach going forward.

VII. IN THE GAMESTOP AFTERMATH

Since those fateful days back in the early part of January 2021, a lot has changed. Gabriel Plotkin, the Melvin Capital founder has decided to liquidate the hedge fund and return what is left of its capital to its investors.[194] Melvin Capital never recovered fully from the financial hit it suffered because of the attempted GameStop short sell.[195] Melvin Capital lost some 53 percent of its $12 billion in capital.[196] Bailouts from Citadel Securities and Point72 nearing $2.75 billion were not enough to save the foundering company.[197]

Robinhood, on the other hand, who was a privately held company during the early part of 2021 at the time its customers were exacting their short squeeze on GameStop, has since gone public, issuing its shares on the NASDAQ in August of 2021.[198] Mr. Tenev brought the company to the market with much hype and optimism.[199] In his interview with the Associated Press, Mr. Tenev stated he "wants Robinhood to be the only app that people use on their phones for money. That covers everything from depositing paychecks to paying bills to splitting payments with friends."[200] Early returns, however, suggest that the online brokerage concern is not living up to its billing. A CNN news article stated:

It's been one year since Robinhood went public. And to say that the online broker's performance has been disastrous would be a massive

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193. Alexander Jones, *GameStop: One Year Since Retail Investors Took on Wall Street*, INT'L BANKER (Feb. 23, 2022), https://internationalbanker.com/brokerage/gamestop-one-year-since-retail-investors-took-on-wall-street/ [https://perma.cc/2FLF-8U5Z].

194. Goldstein & Kelly, *supra* note 81.

195. *Id.* Melvin Capital lost some 53 percent of its $12 billion in capital.

196. *Id.*

197. *Id.*

198. Stan Choe, *Robinhood Goes Public, Eyes Expansion Beyond Trading*, PBS (July 29, 2021), https://www.pbs.org/newshour/economy/robinhood-goes-public-eyes-expansion-beyond-trading [https://perma.cc/QFX9-BDTR].

199. *Id.*

200. *Id.*

understatement. If someone were to write a kids' book about it, they could title it "Robinhood and the Terrible, Horrible, No Good, Very Bad Year."[201]

The article further discusses Robinhood's floundering stock price, which debuted at $38 back in August of 2021 when it first went public.[202] Its shares plummeted to $9 per share in late July 2022.[203] As of this writing, the shares were still languishing at $9.47 per share.[204] The article cites Robinhood's no-fee trading model as part of the problem.[205] The article takes the position that the app's casino-like interface has made investing seem more like a game rather than the very serious investment endeavor that it actually is. The article cites these aspects of the app as part of the problem.[206]

Finally, as of this Article's publication date, there have not been any more high-profile high stakes short sell versus short squeeze incidents since the one that occurred with GameStop that pitted Robinhood's retail investors against the hedge fund firm Melvin Capital. Although PFOF is heavily scrutinized, the SEC continues to allow it although it has made clear that it will continue to watch the practice and may reconsider the question of banning the practice at some point in the future.[207]

VIII. SOLUTIONS

A. TIME TO REVISIT THE CUSTOMER SUITABILITY RULES?

FINRA Rule 2111 has factors that brokers must consider when making investment recommendations to their customers.[208] Those factors include, "the customers' age, other investments, financial situation and

201. Paul R. La Monica, *HOOD-winked? Investors Not Celebrating One Year After Robinhood's IPO*, CNN BUS. (July 29, 2022), https://www.cnn.com/2022/07/29/investing/robinhood-ipo-stock-anniversary/index.html [https://perma.cc/KM85-2UKA].

202. *Id.*

203. *Id.*

204. *Robinhood Markets, Inc. (HOOD)*, YAHOO FIN., https://finance.yahoo.com/quote/HOOD/.

205. La Monica, *supra* note 201.

206. *Id.*

207. Sabrina Escobar, *SEC May Not Ban Payment for Order Flow, Sending Robinhood Higher*, FIN. NEWS (Sept. 22, 2022), https://www.fnlondon.com/articles/sec-may-not-ban-payment-for-order-flow-sending-robinhood-higher-20220922 [https://perma.cc/9P2P-N497].

208. FINRA Rule 2111 (2010), available at https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111.

needs, tax status, investment objective, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose."[209]

The SEC approved FINRA Rule 2111 in November 2010, and the Rule became effective on July 9, 2012.[210] And as is often the case, the wheels of commerce moved faster than the statutes and rules enacted to govern those practices. Perhaps it is time to revisit the investor suitability model. When the FINRA suitability rules were first promulgated, brokers did not provide no-fee customer trading.[211] Retail traders were not executing trades over their phones,[212] and "gamification" was done at an arcade when a game called "Pac-Man" was all the rage.[213]

The investing world is different now and lawmakers, regulators, brokers, and retail investors are all scrambling to find their footing in this new trading environment that provides easy access to buying and selling in the markets. Brokers like Robinhood have created a new "game like" environment for trading that simulates the dopamine-producing sensation that rivals casinos, where nonetheless, the risks and rewards of good versus poor investment decisions remain the same.[214]

The dilemma is a real one and the industry is going to have to make up its mind where it wants to set the dial on the investor protection spectrum. And then they will have to live with the fallout.

There will never be a perfect solution here. If regulators restrict certain types of investment strategies or practices—such as options trading and margin lending—to more experienced investors, then there will be outcry from those investors who feel like they should be afforded such access and are being denied the same wealth building opportunities and strategies as others. Then, on the other hand, if you afford them the

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209. *Id.*

210. FINRA Regulatory Notice 12-55, *Suitability: Guidance on FINRA's Suitability Rule* (2012).

211. Augustine O. Ojeh, *3 Things to Know About Robinhood and Zero-Commission Stockbrokers*, YAHOO FIN. (Sept. 28, 2021), https://finance.yahoo.com/news/3-things-know-robinhood-zero-110000284.html [https://perma.cc/4GP8-RWCD].

212. Katie Martin & Robin Wigglesworth, *Rise of the Retail Army: The Amateur Traders Transforming Markets*, FIN. TIMES (Mar. 8, 2021), https://www.ft.com/content/7a91e3ea-b9ec-4611-9a03-a8dd3b8bddb5 [https://perma.cc/VJX8-QP3W].

213. Jennifer Rosenberg, *Pac-Man Video Game History and Background*, THOUGHTCO. (Mar. 24, 2020), https://www.thoughtco.com/pac-man-game-1779412 [https://perma.cc/BZ6U-SMK6].

214. Popper, *supra* note 39.

full range of investment products such as margin lending and options trading that many of them are insisting on having, they end up suffering significant losses due to ill-advised decisions and lack of true knowledge as to what they are dealing with. The industry then faces the fallout from that end, as investors will blame their brokers for allowing them access to investment tools that the investor did not have the knowledge or experience to handle.

B. Gamification

The other aspect that has been alluded to periodically in this piece which also has a bearing on the investor experience are what are referred to as "Digital Engagement Practices" ("DEPs"), or also referred to as "gamification."[215] Simply put, these are the bells and whistles on an investment app to enhance the user's experience.[216] As these DEPs relate to the investor experience, questions have arisen as to how these DEPs are affecting not only the investor experience, but investor decision making.[217]

In October of 2021, the SEC issued Release Numbers 34-92766; IA-5833; File No. S7-0-21.[218] The SEC invited all constituents, investors, industry participants, and all others to give input through commenting on aspects relating to the broker customer relationship and particularly the digital online trading experience.[219] The SEC's main focus with this release was the DEP experience.[220] Sample questions were the following:

> 1.1 What types of DEPs do firms use (or in the future expect to use) on digital platforms and what are the intended purposes of each type of DEP used? For example, are particular DEPs designed to encourage or discourage particular investor actions or behaviors, such

215. Alex Padalka, *Robinhood to SEC: Digital Engagement Rules Could Violate First Amendment*, FIN. ADVISOR (Oct. 8, 2021), https://www.financialadvisoriq.com/c/3351804/424454/robinhood_digital_engagement_rules_could_violate_first_amendment [https://perma.cc/W8YF-XV2N].

216. *Id.*

217. *Id.*

218. Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology to Develop and Provide Investment Advice, SEC Request for Information and Comment, No. 34-92766 (Oct. 1, 2021) [hereinafter SEC Request].

219. *Id.*

220. *Id.*

> as opening of accounts, funding of accounts, trading, or increasing engagement with the app or platform?[221]
>
> 1.2 To what extent do firms that utilize DEPs provide retail investors the ability to opt in or out of interacting with those DEPs when using the firm's digital platform?[222]
>
> 1.3 What types of firms use DEPs on their digital platforms, and on what types of platforms? Are these practices more prevalent among certain types of firms, or on certain types of platforms?[223]
>
> 1.4 What market forces are driving the adoption of DEPs on digital platforms and how? For example, to what extent and how is the use of DEPs influenced or driven by market practices related to compensation and revenue (e.g., "zero commission" and PFOF)?[224]

As one might imagine, the responses were varied and wide–ranging. Some responses had strong feelings against DEPs, noting that their design seemed geared toward incentivizing behavior that runs contrary to sound investment behavior. For example, a number of DEP features are designed to induce more frequent trading, which studies have shown tends to reduce an investor's return on investments over time.[225] On the other hand, some industry participants stood behind DEP practices as encouraging investor education, solid investment strategies, and wealth-building sound practices.[226] Those advocates also expressed concerns that the SEC might be over reaching and cautioned that if the SEC stepped in and curtailed DEP practices, the SEC would be stifling innovation in this space, which in the long run could prove more harmful to investors than helpful.[227]

In sum, the appropriate action course depends on your perspective. There is no easy answer or fix. The more regulators try to protect, the

221. SEC Request, *supra* note 218.
222. *Id.*
223. *Id.*
224. *Id.*
225. Brad M. Barber et al., *Attention Induced Trading and Returns: Evidence from Robinhood Users*, J. FIN. (forthcoming) (manuscript at 29), https://ssrn.com/abstract=3715077.
226. *See* Kristen Malinconico, *Re: Request for Information on Digital Engagement Practices (File No. S7-10-21)*, CTR. FOR CAP. MKTS. (Oct. 29, 2021), https://www.sec.gov/comments/s7-10-21/s71021-9361127-261711.pdf.
227. *Id.*

more they will restrict. The more regulators restrict, the more the opportunity scope for a subset of investors will be narrowed. And the "gamification" of investing appears like a genie that will not be put back into its bottle. The young investors now entering the world of investing largely through these online, no-fee trading applications have come to expect gamification as part of the experience, as manipulative and behavior inducing as it may be. So, there are tradeoffs here as is the case in most contexts.

Nonetheless, there are things already in the works that, hopefully, will address some of these issues. Now, having the benefit of hindsight, there are practices that the industry can adopt that, at the very least, will absolve the broker side of the equation from not being more transparent about some of the pitfalls that come with investing generally, and non-directed online investing more specifically.

C. LIMIT THE TIME BETWEEN TRADE DATE AND SETTLEMENT DATE

The most effective, straightforward, and impactful solution to this issue is to reduce the time between the trade date and the settlement date. Indeed, this proposal is not controversial as it has been in the works for some time now—even prior to the whole GameStop short sell, short squeeze palaver. The DTCC, along with its subsidiaries the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC), has had a history of shortening the time between the trade date and the settlement date.[228] The effort to shorten the time between those two dates originated in 1995, when the DTCC shortened the time between trade date and settlement date from 5 days to 3—i.e. (T+5) to (T+3).[229] Furthermore, "[i]n collaboration with the industry, DTCC completed the transition to T+2, further accelerating settlement by an entire day."[230] The amount of effort, collaboration, protocol, and practice to reduce trade day times is significant and it involves many moving parts. This explains the time involved in reducing the time between trade date and settlement.

The DTCC is once again on the precipice of reducing the time between the trade date and the settlement date from 2 days to 1—(T+2)

228. DEPOSITORY TR. & CLEARING CORP., ADVANCING TOGETHER: LEADING THE INDUSTRY TO ACCELERATED SETTLEMENT 13 (Feb. 2021).

229. *Id.*

230. *Id.*

to (T+1).[231] There is not much controversy surrounding this effort. The industry seems to be onboard with the move as it will be a win-win.[232]

Moving from T+2 to T+1 would reduce the notional (principle) value of unsettled trades from roughly $90 billion to $45 billion.[233] The reduced day of trading would then allow brokers (and their clients) to free up that excess capital and put it to use in the market versus being in the stagnant role of serving as collateral for unsettled trades. Given the DTCC's current progress on this effort, they are predicting that the industry will move to T+1 by 2024.[234]

D. WHY NOT T+0?

The effort to move from T+2 to T+1 invites the question, why not make trading and settlement an instantaneous transaction, thereby reducing the need for margin and collateral requirements altogether? The answer is that a move to T+0 would create inefficiencies that would end up costing the market more. The DTCC, through its subsidiaries, processes over 1 million trades per day.[235] In order to handle trade volume of this magnitude, the DTCC engages in a process called "netting," whereby the DTCC, instead of handling each trade on an individual basis, at the end of the day simply nets out the "buys" and "sells" of all the broker transactions placed throughout the day.[236] The netting process obviates the need to handle transactions on an individual basis.[237] Thus, the industry consensus is that a move to a T+1 trade date to settlement

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231. *Id.*

232. *See* Bill Meenaghan, *The Move to T+1 in the US – Who Really Benefits?*, S&P GLOB. (May 6, 2022), https://www.spglobal.com/marketintelligence/en/mi/research-analysis/the-move-to-t1-in-the-us-who-really-benefits.html [https://perma.cc/9HDC-WBPW].

233. Shortening the Securities Transaction Settlement Cycle, Exchange Act Release Nos. 34-94196, 173 (proposed Feb. 9, 2022) (to be codified at 17 C.F.R. pts. 232, 240 & 275).

234. *Accelerating to T+1: What You Need to Know*, DTCC (Apr. 6, 2022), https://www.dtcc.com/dtcc-connection/articles/2022/june/06/accelerating-to-t1-what-you-need-to-know [https://perma.cc/68BG-82VY].

235. Michele Hillery, *Moving to One Day Settlement: A Win for Investors and the Industry*, DTCC (Feb. 3, 2022), https://www.dtcc.com/dtcc-connection/articles/2022/february/03/moving-to-one-day-settlement-a-win-for-investors-and-the-industry [https://perma.cc/9PGZ-HDQ3].

236. DEPOSITORY TR. & CLEARING CORP., *supra* note 228, at 4.

237. *Id.*

date would be optimal. Efforts are currently underway to achieve that with the projected date being 2024.[238]

E. Caps on Margin Lending

Another option is to terminate margin lending altogether. Customers would be prohibited from borrowing money to buy stocks. The author acknowledges that this suggestion may be a non-starter for both the broker and the customer.

The idea behind margin lending, as with all leverage, is that it allows an investor to use other people's money to optimize access to potentially wealth building assets.[239] Currently, margin lending practices allow investors to buy up to twice what they could otherwise afford, as brokers allow their customers to borrow to the extent of deposited assets.[240] If that borrowed money, coupled with the investor's own assets, is put towards stocks that increase in value, that is a win-win proposition for both the investor and the broker. The broker makes money off the interest on the borrowed funds, and the customer makes money off buying stocks that increase in value.[241]

The clear downside is the situation where the customer buys shares on margin, and the shares decrease in value. Because the broker has the legal option to liquidate the investor's account to cover the losses, the broker is protected to a large extent.[242] But the customer can potentially lose everything. The follow up question, then, is: should customers be protected from this potential downside by limiting the customer's ability to purchase shares on margin?

Keeping in mind the typical demographic of Robinhood's retail customers,[243] the thought here is that this investor demographic does not know any better; that they should be protected from themselves. This argument has merit. The combination of liberal margin lending practices,

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238. *Accelerating to T+1: What You Need to Know*, *supra* note 234.

239. Matt Whittaker & Miranda Marquit, *Should You Use Brokerage Margin Loans?*, U.S. NEWS (May 19, 2021), https://money.usnews.com/investing/investing-101/articles/should-you-use-brokerage-margin-loans [https://archive.ph/51OL2].

240. *Understanding the Benefits and Risks of Margin*, FIDELITY, https://www.fidelity.com/learning-center/trading-investing/trading/understanding-benefits-risks-margin [https://archive.ph/Wk8Br].

241. *Using Your Securities to Borrow Money*, FIDELITY, https://www.fidelity.com/learning-center/trading-investing/trading/margin-borrowing [https://archive.ph/Oq3nS].

242. *Id.*

243. Tuwiner, *supra* note 169.

a customer base that has a proclivity for high risk, and those persons' relative lack of investor knowledge and sophistication is a combination that could end up in adverse financial outcomes for this group. And in fact, the numbers have been bearing this out.

When the GameStop short sell was occurring, Robinhood had a "remarkably high" amount of bad debt expense relative to other online brokers.[244] "Bad Debt Expense" in this context refers to loans that a broker has made to its customers but the customers have defaulted.[245] In that event, Generally Accepted Accounting Principles require the broker to record those amounts as expenses and recognize the expense on the broker's income statement.[246] Of the $1.4 billion Robinhood had loaned as of June 30, 2020, the company had just over $47 million in "doubtful accounts."[247] By comparison, E*TRADE had $9.8 billion in margin loans outstanding, according to its most recent filing, but only $9 million—or roughly 0.1 percent—in doubtful accounts.[248] These numbers show that the customers trading on Robinhood are defaulting on their margin loans at a much higher rate than with other online brokers. That conclusion aligns with the younger, less experienced, and more risk tolerant customer demographic more emblematic of a Robinhood trader than on other trading platforms.

Further on these points, pundits have pointed out that more experienced or professional investors who use margin lending do not use this leverage to engage in the riskier, more speculative stock plays that the Robinhood investors are and have been engaging in.[249] The more professional experienced investors use margin lending to perhaps double down on the stable, well-established companies such as Microsoft, IBM, or UPS.[250]

Thus, Robinhood—the self-professed advocate that touts making access to the markets more accessible—may also be making it far too easy for these investors to fall into financial straits again by allowing them access to investment tools prior to them having the requisite experience

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244. Gandel, *supra* note 158.
245. *See Bad Debt Expense Definition*, ACCOUNTINGTOOLS (Jan. 23, 2023), https://www.accountingtools.com/articles/bad-debt-expense.
246. *Id.*
247. Just over 3 percent of the outstanding loan balance. Gandel, *supra* note 158.
248. *Id.*
249. *Id.*
250. *Id.*

and financial sophistication to manage those tools in a more fiscally responsible manner.

In all likelihood, both brokers and customers would rail against limits on margin lending. The brokers will not be interested at all in leaving this close to risk-free revenue source on the table. And the customers, in perhaps their inflated belief in their own abilities, will not want their upside potential capped by setting limits or prohibiting their ability to buy stocks on margin.

F. SUITABILITY SCORES

A possible compromise here might be some version where brokers lend on margin based on a Suitability Score. A Suitability Score may be composed of a number of factors, such as:

> 1) Years of investing experience as demonstrated by the investor's ability to show when they first commenced investing in publicly traded companies;
>
> 2) Investor's Net Worth;
>
> 3) Amount of money on deposit with the broker (which is already a factor);
>
> 4) Whether the investor has fallen into the category of Pattern Day Trader.

Engaging in margin lending based on risk profile would be a compromise to the current practice which leaves too much opportunity for novice investors to fail. Arguably, since we are dealing with adults capable of making their own decisions, oversight and Suitability Scores are an overreach. it's interesting to note, however that conventional lenders, such as banks, engage in this very practice.[251]

The amount of money banks are willing to lend and the price the banks will charge you to lend are based on, among other things, a credit score which takes into consideration far more criteria than those listed here.[252]

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251. Megan DeMatteo, *This Is the Credit Score Lenders Use When You Apply for a Mortgage*, CNBC (Dec. 2, 2020), https://www.cnbc.com/select/which-credit-score-used-when-applying-for-mortgage/ [https://perma.cc/8ZSB-XB8V].

252. *Id.*

Banks will require you to demonstrate a high probability of being able to repay the loan before lending the money, and the price that they will charge is based on the borrower's credit score. The same goes for financing a car purchase, boat purchase, or any high-priced asset.[253]

The double standard likely stems from the fact that lenders in these other contexts are more exposed and are at a greater risk than in the broker/customer context. In the broker/customer scenario, it is the customer that bears the bulk of the risk of loss. This is so because the lending brokers have ready and easy access to the collateral that is securing the margin loan, i.e., the customer's portfolio of stocks that have been purchased through the broker.[254] The broker/customer agreement affords the broker access to the stock in the event the customer breaks certain financial tripwires.[255] The broker can sell the defaulting customer's shares easily in the liquid market and recoup most or all of any amounts in default.[256] With minimum risk to the broker, it becomes apparent why the broker is willing to allow its customers to purchase shares on margin. If things go south, the customer bears most of the risk and has most of the exposure.

Compared to the conventional bank loan context, the banker's risk of loss is greater, for example, mortgage lending. In the mortgage lending context, the home is the asset used for collateral.[257] In the event of a default, the bank has the right to foreclose on the home, take possession of the property, and re-sell the home to pay down the borrower's outstanding balance.[258] Here, however, the process is much more time consuming and cumbersome. The process of foreclosing on a home could take years instead of days, such as in the broker/customer scenario.[259] So, where the risk of avoiding loss requires much more, we see the lender

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253. Troy Segal, *5 Cs of Credit: What They Are, How They're Used, and Which Is Most Important*, INVESTOPEDIA (Mar. 17, 2023), https://www.investopedia.com/terms/f/five-c-credit.asp [https://perma.cc/87GH-QF8H].

254. *Using Your Securities to Borrow Money*, *supra* note 241.

255. *Id.*

256. *Id.*

257. David McMillin, *What Is Collateral and How Does It Work in the Mortgage Loan Process?*, BANKRATE (Mar. 17, 2022), https://www.bankrate.com/mortgages/collateral-for-mortgage/ [https://perma.cc/K6VQ-W4TN].

258. *Id.*

259. Diane Costagliola, *What Is a Foreclosure? How It Works and How to Avoid It*, BANKRATE (Aug. 10, 2022), https://www.bankrate.com/mortgages/what-is-a-foreclosure/ [https://perma.cc/2WKS-T2WA].

requiring more exacting standards prior to lending—an arguable double standard here. The lenders will take steps to protect themselves, but what about steps to protect the borrower?

G. INFORM BROKERAGE CUSTOMERS THAT THEIR TRADING COULD BE RESTRICTED

The typical customer broker agreement is extensive and affords the broker unfettered discretion to take certain actions when warranted regarding the customer's account.[260] The Robinhood customer agreement for example states:

> You Understand that Robinhood may at any time, at its sole discretion and without prior notice to you; (i) prohibit or restrict your access to the use of the platform or related services; (ii) restrict your ability to deposit or withdraw funds, or trade securities in your account; or (iii) terminate your account.[261]

Note, the Agreement does not put any caveats as to when and under what circumstances Robinhood is authorized to take such action.[262] Accordingly, when Robinhood restricted account access back in January 2021, Robinhood was well within its contractual rights to do so.[263] Whether the customers were aware of Robinhood's contractual rights or not, from a legal standpoint Robinhood was acting within the four corners of the Customer Broker Agreement.[264]

From a business and customer relations standpoint, however, it would be best practice to explain in the Agreement what types of events might trigger restriction. Specifically, an occurrence of high trading volume on a volatile stock—such as the situation with GameStop—could be explained. Informing customers of this possibility, even though unlikely, would pre-empt the backlash that was targeted at Robinhood.[265] Granted, now that the unprecedented event has occurred, with no reported reoccurrences of similar instances to date, such disclosure may not be as pressing. But again, even though the GameStop incident was high profile

260. *See* ROBINHOOD FINANCIAL LLC & ROBINHOOD SECURITIES, LLC, CUSTOMER AGREEMENT 10, 38 (Sept. 30, 2022), https://cdn.robinhood.com/assets/robinhood/legal/Robinhood-Customer-Agreement.pdf [hereinafter CUSTOMER AGREEMENT].

261. *Id.* at 10.

262. *See id.*

263. *See id.*; *see also* Leonhardt, *supra* note 1.

264. *See* CUSTOMER AGREEMENT, *supra* note 260.

265. *See* Egan, *supra* note 7.

and highly publicized, first time and novice investors may nonetheless be unaware.[266] Thus, a transparent and clear warning, would result in an investor who is better informed when entering into the retail investor space for the first time.

H. INACTION

Inaction is always an option. The stock market is also a free market. Participating in it is voluntary. "Buyer beware" is the watchword. The issue with the "inaction" option, however is that there is a symbiotic relationship between the players in the market, and that should be acknowledged. Recall the process involved with settling trades which spans a two-day period and requires that the broker representing the purchaser meet the DTCC's collateral requirements.[267] Earlier, this Article advocated for closing that time period between trading and settling trades from two days down to one. But as long as trades are being executed with the two-day time period, it seems like there should be some dispensation for all that is involved in executing those trades safely and maintaining an orderly market.

As discussed earlier, the brokers are required to provide collateral to the DTCC, with the amount of collateral contingent upon the risk associated with the corresponding stock; riskier more volatile stocks require more collateral.[268] It is the customers that are selecting the stocks, however, not the broker. So, it is the customers that drive risk levels through their stock picks, but it is the brokers who have to provide the corresponding collateral to the DTCC.[269] The current trading and settlement process creates a disconnect between the party making the stock selections (the customer), and the party responsible for hedging against the corresponding risk (the broker).

Inaction risks another situation like the one with Robinhood and its customers, where Robinhood made the discretionary decision to protect itself from greater exposure by restricting its customers from buying additional GameStop shares.[270] Under the current trading regime,

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266. *See* Wolff-Mann, *supra* note 42.
267. *See* Jasinski, *supra* note 142.
268. *Id.*
269. *See* Csiszar, *supra* note 155.
270. *See* Leonhardt, *supra* note 1.

Robinhood's actions are backed by a solid rationale, i.e., limiting its potential exposure by limiting its customers further trading on a risky stock.

However, Robinhood's exposure is a situation of Robinhood's own making. Engaging in liberal margin lending practices to novice and, potentially reckless investors, provides the customers with the access to the more riskier investment tools to set the high-risk scenarios in motion. But it's the brokers who have the arbitrary discretion to halt trading when, in their assessment, it is prudent to do so.[271] This dynamic has fundamental flaws. Inaction maintains the set of circumstances where a broker will again make the discretionary decision to halt trading due to the exposure becoming more than the broker is willing to bear. Accordingly, I would deem broker inaction as a conscious decision to leave retail investors vulnerable to the same potential restrictive trading scenario that occurred with GameStop. The author acknowledges that the probability of a GameStop situation recurring is low. But it's not impossible.

CONCLUSION

The retail brokerage industry appears to be at an inflection point. Robinhood's practice of no-fee commissions has initiated a shift not only in who participates in the public equity markets but also how they engage in such participation. Younger, less experienced investors, coupled with easier, low-cost access to the markets, and the connectivity of technology and social media, have resulted in market participants who have engaged in novel ways of retail investing with no precedent in scale.[272] In the GameStop short squeeze aftermath, lawmakers wrestle with questions of what, if anything, should be done with this changing investor demographic and the corresponding changes in which they are participating.[273]

The competing tensions are clear - investor protection through limits and relevant guardrails. But protection comes with a price-limiting risk, limits rewards. Limiting access to options trading or margin lending, for example, to novice investors. No doubt some would take issue with that.

271. *See* CUSTOMER AGREEMENT, *supra* note 260.

272. *See* Krishan Arora, *The Rise of the Retail Investor*, FORBES (Nov. 4, 2022), https://www.forbes.com/sites/forbesagencycouncil/2022/11/04/the-rise-of-the-retail-investor/?sh=1c1820321755 [https://archive.ph/HcZuV].

273. *See* Higgins, *supra* note 110.

But by the same token, turning around and taking umbrage when things go south due to that investor’s inexperience and lack of knowledge is the other side of that coin. Investors cannot have no risk and all reward. Tradeoffs will come with whatever policy course is decided here, and investors will have to respond appropriately. If the decision is to fly high and close to the sun, investors will have to accept that some will get burned. If the prevailing policy is bent for more investor protection, then investors will have to appreciate that certain investment vehicles will be off-limits to them until they shed their investor training wheels and have more knowledge and experience with what they are doing. Investing is speculative with no guarantees. That’s the game and those are the rules. All parties, regardless of their leanings, will need to keep that in mind.