THE DEMOCRATIZATION OF FINANCE FOR ALL? A LOFTY BUT IMPROBABLE GOAL AFTER IMPENDING REGULATION

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I. INTRODUCTION

Robinhood, an online brokerage app created to democratize finance for all,[1] united Capitol Hill in opposition against its trading practices after the platform restricted users from purchasing shares of GameStop amid a trading frenzy.[2] Robinhood defended its decision to halt users from purchasing GameStop stock as one rooted in risk management.[3] Nevertheless, Robinhood received blowback from regulators and consumers in the form of historic fines, forty-nine class action lawsuits, and three individual suits.[4] In July 2021, just six months

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1. *Our Mission*, ROBINHOOD, https://robinhood.com/us/en/support/articles/our-mission/ (last visited Sept. 19, 2021).

2. *See* Chris Mills Rodrigo & Sylvan Lane, *Lawmakers rip Robinhood's decision on GameStop*, THE HILL (Jan. 28, 2021, 7:21 PM), https://thehill.com/policy/finance/536411-lawmakers-rip-robinhoods-decision-on-gamestop?rl=1.

3. *Id.* ("To be clear, this was a risk-management decision, and was not made on the direction of the market makers we route to.").

4. Kari Paul, *Robinhood Sees Rapid Growth Even Amid Lawsuits and Historic Fine*, THE GUARDIAN (July 2, 2021, 12:14 PM), https://www.theguardian.com/business/2021/jul/01/robinhood-profits-ipo-lawsuits-fine.

after the GameStop scandal, Robinhood went public, with shares surging past the initial public offering (IPO) price in just five days.[5]

Although such a successful opening might seem to indicate promise for Robinhood, its IPO prospectus reveals a precarious existence imperiled by looming rulemaking.[6] Within its prospectus, Robinhood referenced the GameStop incident forty-five times[7] and thoroughly described the legal and regulatory issues that resulted from that event.[8] More precisely, Robinhood stated its inability to assure that similar incidents would not reoccur while simultaneously acknowledging that regulation aimed at its revenue stream—regulation with the potential of impairing its business model—was being considered partly because of the events of January 2021.[9] Robinhood's impressive market capitalization, valued at $37 billion,[10] likely immunizes the company from suffering total displacement, though it surely is insufficient for Robinhood to achieve its ambitious goal of democratizing finance for all in light of its regulatory vulnerabilities.[11] Premised on the idea that everyone deserves access to financial markets, Robinhood offers commission-free trading regardless of expertise.[12] Robinhood's business structure is fundamentally at odds with consumers' financial welfare, though looming regulations carry the potential to bring Robinhood closer to its core mission. Specifically, new requirements aimed at its revenue source would compel Robinhood to prioritize its consumers' interests above those of itself or its payors. This Comment aims to explore compliance issues faced by Robinhood, as well as the impact of possible regulatory changes to Robinhood's viability.

Section I details the business model utilized by Robinhood and how it differs from its competitors. Section II describes the current regulatory regime for brokerages, specific regulations applicable to

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5. Maggie Fitzgerald, *Robinhood Surges More Than 24%, Blows Past $38 IPO Price*, CNBC (Aug. 3, 2021, 7:55 PM), https://www.cnbc.com/2021/08/03/robinhood-surges-10percent-runs-past-38-ipo-price.html.

6. Robinhood Mkts., Inc., Registration Statement(Form S-1) (July 1, 2021).

7. *See id.* (referring to the GameStop stock incident as the "Early 2021 Trading Restrictions").

8. *See id.* at 34 (discussing the February 18, 2021 Congressional hearing, as well as investigations by various federal and state agencies).

9. *See id.* at 34 (explaining that the majority of Robinhood's revenue is transaction-based, and that new or heightened regulation of transaction-based arrangements leveraged by Robinhood could significantly and disproportionately harm its business model).

10. Gina Chon, *Robinhood is vulnerable to disruption*, REUTERS (Aug. 31, 2021, 4:34 PM), https://www.reuters.com/breakingviews/robinhood-is-vulnerable-disruption-2021-08-31/.

11. *See* Daniel Raddenbach, *Robinhood's Goal Is Not To 'Democratize Finance For All': Don't Expect Gamestop Buyers' Lawsuits To Change That*, MINN. L. REV., Apr. 13, 2021, at 1, 2-3 (explaining that Robinhood's purported goal of democratized finance cannot coexist with its core revenue-generating structure).

12. *See Our Mission*, *supra* note 1.

Robinhood's business model, and compliance issues for Robinhood. Section III examines fundamental business tactics employed by Robinhood that are prime for regulatory reform, the requirements that regulatory agencies might impose to augment consumer protections, and their likelihood of passage.

II. ROBINHOOD'S BUSINESS MODEL

Robinhood's explosion as a financial services provider can be attributed in large part to its pioneering status as the first commission-free trading brokerage.[13] Prior to the development of apps like Robinhood, people would trade by utilizing the services of traditional brokers, execution and "quant" brokers, research firms, or service providers.[14] Despite differences in the level of services provided by institutional brokerages, most brokerages earned money via commissions.[15] Online discount brokerage firms, too, generally charged commissions on every stock trade despite some of their products being commission free.[16] Robinhood's foray into commission-free trading began after its creators observed that an entire demographic of people—particularly investors under forty with limited funds to invest—was being left out by online brokerage firms.[17] These brokerage firms paid fractions of pennies to execute transactions and trades, while investors could pay up to $10 for executing those same transactions and trades.[18]

Robinhood's response to the trading system centered on its mission to democratize finance for all by facilitating trading for new investors.[19] As its aspirational lodestar, the concept of financial democracy guided Robinhood on its goal of securing seats for everyone at the table wishing to participate in the economic market.[20] Robinhood enjoyed tremendous success following its initial release of commission-

13. Shawn Tully, *Robinhood has Long Championed Small Investors. But its IPO Pounded Them*, FORTUNE (July 29, 2021, 6:00 PM), https://fortune.com/2021/07/29/robinhood-ipo-small-investors-hood-stock/.

14. Andre Cappon, *The Brokerage World Is Changing, Who Will Survive?*, FORBES (Apr. 16, 2014, 11:46 AM), https://www.forbes.com/sites/advisor/2014/04/16/the-brokerage-world-is-changing-who-will-survive/?sh=754e0e8c68a7.

15. *Id.*

16. Melanie Cherdack, *Trading in the Time of COVID: A Robinhood Bromance*, 28 PIABA B.J. 159, 159-60 (2021).

17. *See id.*

18. Cherdack, *supra* note 16, at 160.

19. *Our Mission*, *supra* note 1.

20. *Let's Democratize Wall Street*, ROBINHOOD, https://robinhood.engineering/lets-democratize-wall-street-11e873a91b72 (last visited Jan. 14, 2021) [https://web.archive.org/web/20210805205638/https://robinhood.engineering/lets-democratize-wall-street-11e873a91b72?gi=3adb158a3ad8](describing Robinhood's desire to ensure representation in Wall Street, irrespective of race, gender, education, or financial literacy).

free trades of stocks and exchange-traded funds.[21] Differentiating it from traditional brokers and most online discount brokerage firms, Robinhood created a business model that did not depend substantially on commissions. Instead, Robinhood set up a system disproportionately reliant on a form of transaction-based revenue known as payment for order flow (PFOF).[22] The trading app's reliance on PFOF is so entrenched that PFOF is currently on track to account for a higher percentage of total revenue earned in 2021 than it did in 2020.[23]

Given that Robinhood generates the vast majority of its revenue from PFOF, the brokerage benefits from the constant addition of new users who frequently trade stocks and exchange-traded funds.[24] Under the PFOF business model, brokerage firms are compensated by market makers for routing their customers' orders to them.[25] To entice new members into its trading platform, Robinhood offers a free first stock upon sign up.[26] During the COVID-19 pandemic, when the federal government was issuing stimulus checks to individuals falling within certain tax brackets, the trading app expanded margin lending and offered customers "free cash" for deposits.[27] Robinhood also employs gamification techniques to generate trades.[28] Critics have singled out Robinhood's choice of bright colors for cryptocurrencies as well as the prominent display of stocks making the biggest daily moves.[29] Coincidentally, the most conspicuous sign of the app's gaming approach—a shower of confetti triggered by the execution of transactions—was nixed months before its IPO in response to

21. Cherdack, *supra* note 16, at 161-62; *see* David Ingram, *Designed to Distract: Stock app Robinhood risks*, NBC (Sept. 12, 2019, 1:59 PM), https://www.nbcnews.com/tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071.

22. *See* 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; Robinhood Mkts. Inc., *supra* note 6, at 34 (explaining that PFOF refers only to equities and options trading).

23. Robinhood Mkts. Inc., *supra* note 6, at 34 (stating that PFOF and Transaction Rebates accounted for 75% of Robinhood's total revenue in 2020; by the end the first quarter in 2021, they represented 81% of total revenues).

24. Cherdack, *supra* note 16, at 163.

25. *Id.*

26. ROBINHOOD, https://robinhood.com/us/en/ (last visited Sept. 19, 2021).

27. Matt Egan, *Massachusetts Wants to Pull the Plug on Robinhood*, CNN (Apr. 15, 2021, 4:41 PM), https://www.cnn.com/2021/04/15/investing/robinhood-app-licensemassachusetts/index.html.

28. *See* David Ingram, *Designed to Distract: Stock app Robinhood Nudges Users to Take Risks*, NBC NEWS, (Sept. 12, 2019, 1:59 PM), https://www.nbcnews.com/tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071.

29. *Id.*

considerable criticism.[30] In lieu of confetti, users are now treated to celebratory animations upon the purchase or sale of transactions.[31]

Robinhood's undiversified revenue stream and its necessity to continue enticing new and existing customers present unique challenges for the company. As Robinhood disclosed in its IPO prospectus, 2020 was the first year since its inception in 2013 that it did not incur operating losses.[32] Moreover, despite its dependence on PFOF, Robinhood has a limited number of business relationships with market makers.[33] The obligations owed by market makers to Robinhood are equally troublesome given that no binding contract exists between the parties.[34] Robinhood does, however, owe a duty to its customers as a broker, a duty that could be questioned because of its status as a broker-dealer. The Securities and Exchange Commission (SEC) stated that PFOF raises a potential for conflicts of interest for broker-dealers who handle customer orders.[35] New regulations targeting either PFOF or duties owed to customers by broker-dealers could have an outsized impact on Robinhood due to its current inflexible business structure.

III. EXISTING REGULATORY FRAMEWORK

The Great Recession showcased the inefficiencies of a system lacking in robust regulatory protections. In response to the financial crisis, regulatory agencies imposed on traditional financial institutions an array of comprehensive regulations covering reporting obligations and capital requirements.[36] Companies operating under the fintech umbrella,[37] however, benefited from the imposition of stringent regulations. Not only were fintech companies not subject to the same requirements, they were also exempt from complying with a tailored regulatory framework.[38] Consequently, state and federal regulators

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30. Stan Choe, *Robinhood Cans the Confetti, Unveils new Celebratory Designs*, AP NEWS (Mar. 31, 2021), https://apnews.com/article/business-3c83ae69e7dbc4ddc825e9af308e9c78.

31. *See id.*

32. Robinhood Mkts., Inc., *supra* note 6, at 3, 34.

33. *See id.* at 10, 35 (explaining that for Q1 2021, four market makers accounted for 59% of total revenues).

34. *Id.* at 35.

35. *See* Payment for Order Flow, Exchange Act Release No. 34-34902, 59 Fed. Reg. 55006, 55006-009 (Nov. 2, 1994).

36. Siqi Wang, *Consumers Beware: How Are Your Favorite "Free" Investment Apps Regulated?*, 19 DUKE L. & TECH. REV. 43, 47 (2021).

37. Sean Peek, *What Is Fintech? Definition, Evolution and Examples*, U.S. CHAMBER OF COM. (June 11, 2020), https://www.uschamber.com/co/run/business-financing/what-is-fintech (explaining fintech as enterprises whose "primary objectives are to change the way consumers and businesses access their finances and compete with traditional financial services").

38. *See* In Lee & Yong Jae Shin, *Fintech: Ecosystem, Business Models, Investment Decisions, and Challenges*, 61 BUS. HORIZONS 35, 37 (2017) (explaining that fintech requirements are not subject to

implemented a patchwork of requirements for fintech companies depending on the financial products and services provided.[39]

The multitude of services offered by Robinhood—a fintech enterprise—expose it to numerous compliance requirements with varying regulatory agencies. As a broker-dealer, Robinhood is regulated by the SEC and must comply with all broker-dealer requirements.[40] The online brokerage app is also a member of the Financial Industry Regulatory Authority (FINRA), a self-regulatory agency overseen by the SEC and tasked with the regulation of brokerage firms conducting business with the public.[41] Additionally, customers' money is protected by the Securities Investor Protection Corporation (SIPC) up to $250,000 for cash claims and $500,000 for securities.[42] Although the SEC, FINRA, and SIPC operate as separate entities, they often work in tandem by sharing financial reports and relying on each other's findings.[43]

Robinhood's status as a fintech company provided the online app with a competitive advantage over traditional financial institutions at its inception. By entering the market as an online brokerage, Robinhood was able to skirt a broad regulatory framework with only specific regulations applying to its business. That same advantage, however, now presents a problem for Robinhood as a result of its expanding financial services and concomitant regulatory obligations. The regulatory framework created in the wake of the Great Recession failed to include strict guidelines for broker-dealers receiving PFOF. This is especially problematic for Robinhood given the SEC's duty of best execution and FINRA's requirements concerning high standards of commercial honor.[44]

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rigorous regulations because they are heavily influenced by economic policies which frequently change).

39. *See* Erin F. Fonté et al., Hunton Andrews Kurth LLP, *The Financial Technology Law Review: USA*, THE L. REVS. (Apr. 26, 2021), https://thelawreviews.co.uk/title/the-financial-technology-law-review/usa.

40. Robinhood Fin., LLC, Exchange Act Release No. 92591, 2021 WL 3470610 (Aug. 6, 2021) (providing that the duty of best execution is of particular relevance given its violation by Robinhood, but broker-dealers must also abide by recordkeeping rules, general antifraud provisions like the duty of fair dealing, and applicable disclosure, care, conflicts-of-interest, and compliance obligations mandated by Regulation Best Interest).

41. *See* Press Release, Michelle Ong et al., FIN. INDUS. REGUL. AUTH., *FINRA Orders Record Financial Penalties Against Robinhood Financial LLC* (June 30, 2021), https://www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial.

42. *How You're Protected*, ROBINHOOD, https://robinhood.com/us/en/support/articles/how-youre-protected/ (last visited Oct. 4, 2021).

43. SEC. INV. PROT. CORP., 2018 ANNUAL REPORT 4 (2019), https://www.sipc.org/media/annual-reports/2018-annual-report.pdf.

44. FIN. INDUS. REGUL. AUTH., RULE 5310: BEST EXECUTION AND INTERPOSITIONING (2014); FIN. INDUS. REGUL. AUTH., RULE 2010: STANDARDS OF COMMERCIAL HONOR AND PRINCIPLES OF TRADE (2008).

As the SEC has repeatedly explained, a broker-dealer who routes customers' orders for execution is bound by a duty of best execution.[45] Under this duty, a broker-dealer is required to attempt to obtain the best reasonably available terms for its customers' orders given prevailing circumstances.[46] Complying with the duty of best execution can be challenging for broker-dealers who simultaneously execute customers' transactions and receive PFOF from market makers.[47] Although the SEC has assured broker-dealers that receiving PFOF does not imply a violation of the duty, it has also stated that such arrangement raises potential conflicts of interest.[48] These conflicts are particularly acute for Robinhood in light of its entrenched reliance on PFOF as its core revenue stream.

At the heart of the conflict-of-interest issue is something more fundamental than Robinhood standing to benefit tangentially from inferior execution prices: almost the entirety of its business model is rooted in PFOF. This structure produces an inherent incentive to route substantial trades to market makers for execution. Consequently, Robinhood's practices are likely to be continuously scrutinized to minimize the potential for conflicts of interest. Since its pronouncement of the duty of best execution, the SEC has leveraged a mixture of disclosure requirements and periodic reviews as the primary method of addressing conflicts of interest.[49] Under this seemingly lax regulatory regime, Robinhood has paid over $65 million to the SEC for misleading customers and failing to conduct requisite periodic reviews.[50]

Robinhood faces similar compliance issues with FINRA's standards of commercial honor and suitability requirements. Under FINRA Rule 2010, firms are required to maintain high standards of commercial honor and observe just and equitable trade principles when conducting business.[51] Relatedly, Rule 2220 requires companies to communicate with customers in a fair and balanced manner such that all

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45. *See* Disclosure of Order Execution and Routing Practices, Exchange Act Release No. 43,590, 65 Fed. Reg. 75,413 (Jan. 30, 2001).

46. *Id.* at 75,418 (noting the following relevant factors in determining compliance with the duty of best execution: "(1) the size of the order, (2) the trading characteristics of the security involved, (3) the availability of accurate information affecting choices as to the most favorable market center for execution and the availability of technological aids to process such information, and (4) the cost and difficulty associated with achieving an execution in a particular market center.").

47. FIN. INDUS. REGUL. AUTH., REGULATORY NOTICE 21-23 (June 23, 2021) (reiterating that PFOF is a form of economic inducement with the potential to influence brokers handling customers' orders).

48. *Id.*

49. *Id.*

50. Robinhood Fin., LLC, *supra* note 40.

51. Letter of Acceptance, Waiver, and Consent from Robinhood, LLC, to Dep't of Enf't, FINRA (June 30, 2021), https://www.finra.org/sites/default/files/2021-06/robinhood-financial-awc-063021.pdf.

communications are free of false, exaggerated, or misleading claims.[52] Regarding the suitability requirements, companies are prohibited from recommending transactions or investment strategies unless they have a reasonable basis to believe that such recommendations are suitable for customers based in part on their investment profiles.[53] Disregard for these obligations, among others, resulted in a historic fine of nearly $70 million for Robinhood.[54]

It is difficult to imagine strict compliance with FINRA rules without comprehensive regulation targeting PFOF in light of Robinhood's violative conduct consisting primarily of misrepresentations, false information, and inadequate reviews.[55] FINRA rules seek to promote good faith business relations through a mixture of prohibitions on unethical business practices and disclosures of information. However, some of these same requirements are vaguely defined, leading at times to the notion that brokers violate their spirit if not their legal requirements. In Robinhood's case, its business model can disincentivize adherence to the rules as profitability is inherently tied to the volume of transactions executed by users.[56]

Assuming strict adherence to the duty of best execution, Robinhood's profitability would depend almost exclusively on increased transactions which would in turn depend on either increased executions by existing customers or the acquisition of new customers. As evidenced by FINRA's findings, Robinhood has acquired thousands of customers by repeatedly employing misleading tactics and making misrepresentations.[57] Although several violations can be attributed to an overreliance on inadequate technological infrastructure,[58] the bulk of Robinhood's issues appear to emanate from its desire to increase the volume of consumer transactions.[59]

In the absence of a regulatory framework aimed at addressing PFOF, Robinhood is likely to continue contravening its duties to consumers. Robinhood's business strategy incentivizes it to engage in

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52. *Id.*

53. FINRA, RULE 2111(a)(2020)("A[n] [] investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance . . . .").

54. *See* Letter from Robinhood, LLC to Dep't of Enf't, FINRA, *supra* note 51 (consenting to a $57 million fine and more than $12.5 million in restitution).

55. *See* FINRA, REGULATORY NOTICE 21-23, *supra* note 47, at 1,3–4 (noting that PFOF induces broker-dealers to circumvent the duty of best execution even though they are bound by it).

56. Market makers compensate broker-dealers for orders routed to them. An increase in orders yields an increase in compensations.

57. *See* Letter from Robinhood, LLC to Dep't of Enf't, FINRA, *supra* note 51.

58. *Id.*

59. *See* Letter from Robinhood, LLC to Dep't of Enf't, FINRA, *supra* note 51 (citing multiple instances of Robinhood's use of misleading tactics to acquire new customers and approve otherwise ineligible customers for options trading).

conduct that leads to increased transactions, even if some of those transactions are not in its customers' best interests. While adherence to existing requirements can partially balance Robinhood's financial objectives with its legal duties, new regulations centered on consumer protections must be enacted to resolve fundamental conflicts of interest. Until then, Robinhood carries outsized exposure from multiple regulatory agencies.

IV. POTENTIAL REGULATIONS

The GameStop trading frenzy exposed the inadequacy of the existing regulatory regime in protecting consumers from contemporary methods of transacting via digital marketplaces. While regulators and financial experts alike agree that the GameStop scandal revealed the dire need for revamped policies and regulations, many disagree about the proper target and scope of regulatory reform.[60] For some, the GameStop event typified issues surrounding online brokerage apps like Robinhood. For others, the incident was the 'canary in the coal mine' for the stability of financial markets. Those who subscribe to the former view would propose regulations more narrowly tailored for apps like Robinhood, while those who assent to the latter view would advocate for broader regulatory reforms.[61] The preponderant view on the representativeness of the GameStop incident will significantly color the nature of reforms ultimately espoused by regulators.

While the SEC could institute a bevy of regulations and market reforms, this section will focus on those with the greatest potential of affecting Robinhood and its business model.

A. Payment for Order Flow

The rapid expansion of PFOF as a lucrative business model and the attendant explosion in market transactions make PFOF a prime target for regulation. From its inception, PFOF has been met with skepticism because of the conflicts of interest it raises for brokers. Under a duty of best execution, brokers are required to route customer orders to the

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60. *Compare* Kyle Langvardt & James Fallows Tierney, *On "Confetti Regulation": the Wrong Way to Regulate Gamified Investing*, 131 YALE L.J.F. (forthcoming 2021) (proposing regulations aimed at business models like PFOF), *with* Iris H-Y Chiu, *Social Disruptions in Securities Markets—What Regulatory Response Do We Need?*, 28 RICH. J.L. & TECH. 2, 18 (2021) (recommending gatekeeping duties on brokers and investors' use of leverage).

61. *See* Lawrence Goodman et al., *Robinhood and GameStop: Essential Issues and Next Steps for Regulators and Investors,* HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb 23. 2021), https://corpgov.law.harvard.edu/2021/02/23/robinhood-and-gamestop-essential-issues-and-next-steps-for-regulators-and-investors (differentiating between (1) macro risk management and crisis prevention and (2) micro regulatory issues).

markets with the best prices reasonably available.[62] PFOF, however, incentivizes brokers to route order flow to the venues offering the highest rebates as brokers themselves pocket the rebates.[63] Cognizant of these inherent conflicts of interest, the SEC has expressed a willingness to regulate PFOF by either reforming it or banning it entirely.[64]

Proponents of a ban contend that structural features make it difficult to assess compliance with the duty of best execution. The internalization of trades by broker-dealers and the utilization of internal algorithms by market makers can result in poor execution quality.[65] Stemming in part from the broad and imprecise definition of the duty,[66] compliance can be asserted by brokers operating in a variety of methods. In the context of PFOF, its proponents will claim that brokers fulfill their duties by rapidly obtaining for customers price-guaranteed executions.[67] The extent to which a customer might subjectively consider such executions satisfying the duty would depend on their individual preferences.[68] Nevertheless, whether a customer approves of the broker's chosen execution methods is of inconsequential importance as the broker wields virtually unchecked discretion in this field.[69] Accordingly, critics of PFOF stress the importance of removing monetary incentives to capitalize on order flow as a means of strengthening compliance with the duty of best execution.[70]

Instituting a ban would also resolve transparency issues endemic in the current practice of PFOF. Brokers reliant on PFOF have been instrumental in expanding the market for wholesale market makers who compete with exchange specialists, usually away from public exchanges.[71] Orders executed outside public exchanges are problematic

62. *See* Michael A. Hart, *Decimal Stock Pricing: Dragging the Securities Industry into the Twenty-First Century*, 26 LOY. L.A.L. REV. 843, 867 (1993).

63. *Id.*

64. *See* Avi Salzman, *SEC Chairman Says Banning Payment for Order Flow Is 'On the Table'*, BARRON'S (Aug. 30, 2021, 4:46 PM), https://www.barrons.com/articles/sec-chairman-says-banning-payment-for-order-is-on-the-table-51630350595.

65. Joel Seligman, *Payment For Order Flow And the Great Missed Opportunity*, 18 HASTINGS BUS. L.J. 3, 19, 24-25 (2021).

66. *See* Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 S. CAL. L. REV. 1027, 1066-67 (2001) (noting that SEC guidance on what a broker is permitted to do is non-exhaustive, and formulations of the duty from other sources are similarly amorphous).

67. Note, *The Perils of Payment for Order Flow*, 107 HARV. L. REV. 1675, 1678 (1994).

68. *See id.* at 1679 (explaining that customers might prefer to wait for the opportunity to price-improve rather than having their orders executed swiftly at the best price immediately available).

69. *Id.*

70. *Id.* at 1688–89.

71. *See* Hart, *supra* note 62, at 866; *see also* Jacob Gremillion, *Diamond Hands and Regulatory Demands: Gamestop and the Shortcoming of Current Securities Regulation*, 33 LOY. CONSUMER L. REV. 406, 414, 417 (2021).

because they are less transparent and thus exacerbate risks relating to suboptimal trade prices.[72] Wholesale market makers also contribute to the lack of transparency because their PFOF drives retail internalization, a practice that does not require the public display of orders.[73] Failure to disclose order prices leads to an asymmetric availability of information which hurts investors while simultaneously shoring up business for broker-dealers and wholesale market makers.[74] Banning PFOF would alleviate some of these transparency issues as it would kneecap the system that promotes skirting public exchanges and facilitates retail internalization.

Conversely, instituting a ban might amount to using a chainsaw in a situation better suited for a scalpel. Concerns abound regarding the wisdom of shuttering down a practice that has propped open the markets for an entire demographic of people previously unable to participate in stock trading. Without PFOF, some broker-dealers would be unable to offer commission-free trading,[75] a change that would inevitably erect former barriers to trade for consumers. A ban could also drive out brokers dependent on the practice, solidifying the primary exchange's market power and reducing overall competition in the markets.[76] Additionally, even if brokers were to remain operational, questions remain about potential unintended effects of implementing a ban.[77]

While proponents of banning PFOF would argue that other countries have successfully banned[78] or are set to ban PFOF,[79] these international comparisons might be of limited utility. The American

72. *See* Gremillion, *supra* note 71, at 414.

73. *See* RHODRI G. PREECE, CFA INST. DARK POOLS, INTERNALIZATION, AND EQUITY MARKET QUALITY 3 (2012), https://www.cfainstitute.org/-/media/documents/article/position-paper/dark-pools-internalization-equity-market-quality.pdf.

74. *See* Note, *The Perils of Payment for Order Flow*, *supra* note 67, at 1681-83.

75. *See* Bill Alpert, *Robinhood Says It Likely Would Challenge a Ban on Payment for Order Flow*, BARRON'S, https://www.barrons.com/articles/robinhood-ban-payment-for-order-flow-51630617444 (Sept. 3, 2021, 12:14 PM) (reporting that Robinhood was able to offer commission-free trading because of the revenue obtained from PFOF).

76. *See* Ferrell, *supra* note 66, at 1084–85 (claiming that order flow payments encourage brokers to make their orders in bulk so as to realize economies of scale and to reduce brokerage search costs, and that side payments have served as a way for NYSE competitors to get the attention of brokers).

77. *See* Note, *The Perils of Payment for Order Flow*, *supra* note 67, at 1689 (theorizing that market makers could implement payment methods less likely to be detected or internalize more orders).

78. *See* SVIATOSLAV ROSOV, CFA INST., PAYMENT FOR ORDER FLOW IN THE UNITED KINGDOM 1, 18 (2016), https://www.cfainstitute.org/-/media/documents/article/position-paper/payment-for-order-flow-united-kingdom.ashx (finding that retail trades executed at the best quoted price increased by 25% when, among other things, the UK banned PFOF).

79. Aoife White & Jorge Valero, *EU Set to Ban Trading Practice Helping Power Meme-Stock Mania*, BLOOMBERG (Nov. 9, 2021, 4:01 AM), https://www.bloomberg.com/news/articles/2021-11-09/eu-set-to-ban-trading-practice-helping-power-meme-stock-mania.

market is distinct from other markets—namely, the EU or the UK—because of the greater amount of direct retail trading resulting from investors participating in capital markets.[80] This depth of retail trading engenders a competitive market, obviating the need for deep, structural policy reforms like banning PFOF. Moreover, some of the harms created by PFOF can be mitigated by instituting a series of policies that are cumulatively less stringent. In an effort to improve transparency for investors and strengthen enforcement of the duty of best execution, regulators could require brokers to publicly display internalized orders and wholesale market makers to execute orders within public exchanges.[81] Broker-dealers could also be subject to more scrupulous disclosure requirements and be required to pass a portion of the PFOF directly to consumers.

A ban on PFOF would reform the system profoundly in ways that could harm both consumers and the overall market. While the SEC is currently considering a ban,[82] it is unlikely that they will implement one prior to regulating via incremental changes. In contemplating a ban, regulators should be wary of the social costs it might create for people who might be unable to transact absent commission-free trading. Such a result would be particularly harmful to the image of the SEC as an independent agency given that the GameStop incident occurred in part because of perceived biases in the system favoring institutional investors.[83] A regulatory framework targeting PFOF should ultimately increase consumer protections while ensuring that brokers continue providing access to the market.

B. Regulation National Market System

Although banning PFOF would present a flurry of complications, regulators could nonetheless seek to inhibit its growth by reforming systemic incentives that have fostered its development. Few regulations have had a greater impact on PFOF than the Regulation National Market System (Regulation NMS). Regulation NMS, conceived by the SEC as a means of simultaneously promoting competition among market venues

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80. *See* Chiu, *supra* note 60, at 79-80.

81. *See* Letter from Ellen L.S. Koplow, Exec. Vice President & Gen. Couns., Ameritrade, Inc., to Jonathan G. Katz, Sec'y, U.S. SEC (June 30, 2004), https://www.sec.gov/rules/proposed/s71004/amer063004.pdf.

82. Salzman, *supra* note 64.

83. *See* Elizabeth A. Napps, *Power to the Traders? A Look at the Reddit-Driven Surge of GameStop and Robinhood's Subsequent Suspension of Meme Stocks*, WAKE FOREST L. REV.: CURRENT ISSUES BLOG (Feb. 23, 2021), http://www.wakeforestlawreview.com/2021/02/power-to-the-traders-a-look-at-the-reddit-driven-surge-of-gamestop-and-robinhoods-subsequent-suspension-of-meme-stocks/ (explaining that the SEC is more likely to target individual investors "and may be inclined to take action" against them in the event of another GameStop incident).

and increasing the interaction of customer orders,[84] sought to "modernize and strengthen" the structure of US markets.[85] Chief among its reforms was the prohibition of trade-throughs,[86] which depended upon the enactment of the national best bid and offer (NBBO).[87] The NBBO—a quote disseminated by a central information processor after reviewing information received from market participants[88]—was believed to engender competition by providing reliable and accurate information through the use of consolidated market data.[89]

Pursuant to Rule 611 of Regulation NMS, brokers are required to trade at the NBBO when buying or selling securities for customers.[90] While the NBBO was thought to increase transparency, thereby ameliorating price discovery issues likely to arise in fragmented markets, an appraisal of current market conditions places in doubt the wisdom of such policy absent more rigid requirements and fewer exceptions.[91] Although competition among trading venues indeed grew and the volume of trades skyrocketed—particularly, automated trades as the SEC predicted[92]—a new set of transparency issues continued plaguing the system.[93] Exceptions from the trade-through rule abound within Regulation NMS, many of which narrowly conceived to apply solely to specific trading strategies under limited conditions.[94] In a system dependent on speed,[95] market participants derive economic value from the exploitation of miniscule time gaps between exchanges and the central information processor.[96] The structure of the market, coupled with trade-through exceptions that permit the internalization

84. Stavros Gadinis, *Market Structure for Institutional Investors: Comparing the U.S. and E.U. Regimes*, 3 VA. L. & BUS. REV. 311, 331 (2008).

85. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496 (June 29, 2005).

86. The sale of a security at a price that is lower than a protected bid or higher than a protected offer.

87. Steven McNamara, *The Stock Exchange as Multi-sided Platform and the Future of the National Market System*, 2018 BYU L. REV. 969, 976 (2019).

88. *Id.*

89. Charles R. Korsmo, *High-Frequency Trading: A Regulatory Strategy*, 48 U. RICH. L. REV. 523, 535 (2014).

90. Regulation NMS, 70 Fed. Reg. at 37,501.

91. *See* Paul G. Mahoney, *Equity Market Structure Regulation: Time to Start Over*, 10 MICH. BUS. & ENTREPRENEURIAL L. REV. 1, 3 (2021) (arguing that the structure of U.S. markets is less competitive and less innovative under Regulation NMS).

92. Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,500 (June 29, 2005) (noting that Regulation NMS "will likely lead to a significant expansion of automated trading in exchange-listed stocks").

93. *See* Mahoney, *supra* note 91.

94. Gadinis, *supra* note 84, at 350.

95. Kevin O'Connell, *Has Regulation Affected the High Frequency Trading Market*, 27 CATH. U. J. L. & TECH. 145, 151 (2019) (detailing the outsized control of high-frequency trading—to the tune of 80% of total trading volume—in the United States).

96. McNamara, *supra* note 87, at 1027.

of trades by broker-dealers,[97] incentivizes market participants to transact in secrecy. Unsurprisingly, the exceptions to the trade-through rule are not as narrowly tailored as once anticipated, leading many investors to eschew requirements and deliberately incur higher liquidity costs.[98]

Given the breadth and complexity of Regulation NMS,[99] curing all of its unintended effects seems improbable. Nonetheless, the SEC could loosen its grip on the structure by ameliorating its gravest ills. The technological investments propagated by Regulation NMS are directly intertwined with the rise in high-frequency trading (HFT).[100] The inevitable nexus between the two makes a regulatory response into HFT—as well as other species of algorithmic trading—necessary for a successful reform of Regulation NMS. Regulation Automated Trading (Regulation AT), a withdrawn regulatory strategy, would have provided for expanded oversight of entities engaging in algorithmic trading by compelling the production of proprietary source code.[101] Although such production requests would have likely elicited constitutional concerns,[102] the rationale driving the proposed compulsion was appropriately rooted in a desire to erode HFT's competitive advantage. Stripping away said advantages would not only level the playing field, but it would also reduce price volatility.[103]

While regulators and market participants might disagree on the prudence of singling out HFT, there is little doubt that vigorous reforms such as Regulation AT would bring automated trading closer to the spirit of Regulation NMS as originally envisioned. Regulation NMS inadvertently propped up a system that prioritized speed over price,[104] a paradoxical turn of events given the logic underpinning the NBBO. Admittedly, reverting to a system devoid of speed as a structural feature is impractical without considerable reformation of Regulation NMS.[105] Any reforms, however, whether targeted directly at Regulation NMS or trading practices like HFT, could improve transparency issues even if the market's reliance on speed was not directly addressed.

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97. Korsmo, *supra* note 89, at 536.

98. Gadinis, *supra* note 84, at 352.

99. *See* Hester Peirce, *Meeting Market Structure Challenges Where They Are*, 43 J. CORP. L. 335, 340 (2018) (describing the impact of Regulation NMS on U.S. equity markets).

100. *See* Michael Morelli, *Implementing High Frequency Trading Regulation: A Critical Analysis of Current Reforms*, 6 MICH. BUS. & ENTREPRENEURIAL L. REV. 201, 208 (2017).

101. Regulation Automated Trading; Withdrawal, 85 Fed. Reg. 42,755, 42,756 (July 15, 2020).

102. *Id.* at 42,758 (a request of this nature may have been characterized as an unconstitutional taking of property).

103. *See* O'Connell, *supra* note 95, at 152.

104. *See* Morelli, *supra* note 100, at 206.

105. *Id.*

In its efforts to create a more transparent market, the SEC could close some of the loopholes contained within Regulation NMS, principally the exemptions to the trade-through rule. Broker-dealer internalization and the trading of securities in dark pools are two of several practices obfuscating trades.[106] Market participants engaging in these practices are exempt under the trade-through rule from displaying orders prior to execution. [107] Mandating pre-trading disclosures for internalized orders would result in a more accurate NBBO, which consequently would lead to more reliable data. Conversely, because dark pools are predicated on secrecy and the perceived advantages derived from such arrangement,[108] the SEC is unlikely to abolish their pre-trading disclosure exemption. Nevertheless, the appeal of dark pools could be diminished by instituting a "trade-at" rule, which would oblige brokerages to route orders to public exchanges unless a meaningfully better price could be obtained from a private exchange.[109]

Because of its scope and complexity, reforming Regulation NMS would likely amount to a seismic change in the constitution of U.S. markets. Its passage in 2005 brought about significant modifications to trading—both intended and unintended ones—and a material update might again produce similarly impactful changes. Precisely because of Regulation NMS's influence on market practices, the SEC is unlikely to rescind it in its entirety.[110] Notwithstanding the difficulties in modifying Regulation NMS, the SEC could implement a piecemeal approach at regulatory reform. An incremental strategy could strengthen the markets by mitigating some of Regulation NMS's more troubling consequences and allaying the concerns of those critical of the SEC for assigning itself a role as price regulator.[111] Crucially for brokerages like Robinhood, such reforms—particularly those targeted at HFT—could serve as a proxy for PFOF regulation.

C. Sales Practice Rules And The Standard Of Duty

Regulating the market via sweeping, comprehensive reforms is likely to stir impassioned debates from stakeholders of all stripes. In a bid to limit pushback from market participants, regulatory bodies could

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106. *See* Korsmo, *supra* note 89 at 535.

107. *Id.* at 536.

108. *See* McNamara, *supra* note 87, at 1004-05.

109. Sarah N. Lynch, *Update 1-U.S. SEC OKs 'Tick Size' Pilot, to Include 'Trade-At' Rule*, REUTERS (May 6, 2015, 5:12 PM), https://www.reuters.com/article/sec-test-ticksize/update-1-u-s-sec-oks-tick-size-pilot-to-include-trade-at-rule-idUSL1N0XX3VW20150506.

110. *But see* Mahoney, *supra* note 91, at 43-44 (arguing that the SEC has recently exhibited a willingness to consider meaningful changes to Regulation NMS).

111. *Id.*

specifically target broker-dealers by imposing on them revised standards of conduct. A relatively novel standard known as Regulation Best Interest (Regulation BI) augments the suitability requirements imposed on broker-dealers.[112] With an emphasis on disclosure, diligence, care, and skill, Regulation BI seeks to protect consumers from brokers making recommendations.[113] In the absence of a "recommendation," however, Regulation BI does not apply.[114]

The SEC has explained that the determination of whether an action constitutes a recommendation is subject to a fact-specific inquiry.[115] Relevant factors in the analysis are whether the communication "reasonably could be viewed as a 'call to action'" and whether it "reasonably would influence an investor to trade a particular security or group of securities."[116] Of special significance, as noted by the SEC, is whether communications directed at specific customers are individually tailored.[117] While the SEC could seek to bolster the application of Regulation BI by imposing fiduciary standards on brokers,[118] its current iteration appears sufficiently broad to hamper characteristic elements of trading apps like Robinhood.

Perhaps no features of trading apps are more aptly classified as recommendations than some of the gamification tactics leveraged by brokers. In seeking to increase trades on its platforms, brokers have utilized push notifications and behavioral nudges to replicate video game qualities.[119] Depending on the tailoring of such features, brokers could be subject to the requirements of Regulation BI.[120] Although certain gamification schemes—such as the compilation of trending

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112. *See* Regulation Best Interest, 17 C.F.R. § 240.15l-1 (2019).

113. Kelly Anne Smith, *What Regulation Best Interest Means For Your Financial Advisor*, FORBES,

https://www.forbes.com/advisor/investing/regulation-best-interest/ (Mar. 5, 2021, 1:09 PM).

114. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, Exchange Act Release No. 3486031, 84 Fed. Reg. 33,318, 33,335–33,336 (July 12, 2019).

115. *Id.* at 33,335.

116. *Id.*

117. *Id.*

118. *See* Elizabeth Warren, *Worried About Wall Street Conflicts? The SEC Isn't*, BLOOMBERG (Aug. 3, 2018, 6:00 AM), https://www.bloomberg.com/opinion/articles/2018-08-03/worried-about-wall-street-conflicts-the-sec-isn-t (arguing that a fiduciary relationship, unlike the best-interest standard, is legally defined and should apply to brokers in the same way they apply to investment advisers).

119. 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.

120. *See* Regulation Best Interest: The Broker-Dealer Standard of Conduct, 17 CFR § 240, 245-59 (June 5, 2019),

https://www.sec.gov/rules/final/2019/34-86031.pdf. Under Regulation BI, brokers must satisfy several standards when issuing recommendations. The Care Obligation, with its requirement that brokers have a reasonable basis to believe a recommendation is in the customer's best interest, provides considerable protections for customers.

stocks or the showering of confetti upon the execution of a trade—might not amount to individual tailoring, other features like stock recommendations via push notifications arguably might. Like a prominent billboard displayed on a busy highway, a list of top moving stocks presented on the homepage of an app cannot be said to be individually tailored. Push notifications, on the other hand, stand in stark contrast by their very nature as personalized prompts. While push notifications can be leveraged to transmit generic messages to general groups of people, as in the case of AMBERT Alerts and emergency alerts, they are often utilized to transmit specific information to specific individuals.[121]

In the case of trading apps that collect user information, push notifications are acutely problematic as they invite probing questions into the correlation, if any, of user data and transmitted messages. The more personalized a push notification is, the greater the likelihood that such notification was curated and pushed as a result of data mining techniques.[122] A notification derived from the mining of data is more likely to be interpreted as a direct communication and thus is likely to fall within the ambit of Regulation BI. Robinhood, a company that not only collects user data but also sells it,[123] currently faces a legal challenge from the Massachusetts Securities Division partly because of its push notifications.[124]

Notwithstanding that Massachusetts imposes a strict fiduciary duty on broker-dealers,[125] the regulatory complaint is nationally significant for two principal reasons: (1) it is rooted in Robinhood taking actions amounting to recommendations,[126] and (2) it may inspire other state regulators to enforce fiduciary obligations on broker-dealers. Assuming the state claims are not preempted by federal law, they would address the substantive question of whether Robinhood's push notifications constitute recommendations under Regulation BI. Some of the push notifications cited by the Secretary of the Commonwealth

121. *See* Pierpaolo Loreti et al., Special Issue, *Push Attack: Binding Virtual and Real Identities Using Mobile Push Notifications,* 10, 13 FUTURE INTERNET, no. 2, Jan. 2018, at 67, 67–68.

122. *Id.* at 69.

123. Alex Padalka, *Robinhood, PayPal, Others Sell Personal Data to Third Parties*, FIN. ADVISOR IQ (June 23, 2022), https://www.financialadvisoriq.com/c/3650674/468534/robinhood_paypal_others_sell_personal_data_third_parties.

124. *In re* Robinhood Fin., LLC, No. E-2020-0047, 2020 WL 7711667, at *6 (Mass. Sec. Div. Dec. 16, 2020).

125. *See* Amendments to Standard of Conduct Applicable to Broker-Dealers and Agents, SEC'Y OF THE COMMONWEALTH OF MASS., https://www.sec.state.ma.us/sct/sctfiduciaryconductstandard/fiduciaryrule-adoption.htm.

126. *See In re* Robinhood Fin., LLC, *supra* note 124, at *3.

appear to be directed at infrequent traders.[127] Such notifications could not only be construed as calls to action amounting to recommendations, but they could also be found in violation of FINRA's suitability requirements. A system whose sole criterion for routing users to a list of securities is the volume of trading exhibited by said securities is unlikely to be in compliance with the suitability analysis required by FINRA.

Looking nationally across the regulatory landscape, other states could impose fiduciary obligations on trading apps like Robinhood.[128] Regulation BI was deemed by many to have fallen short of its goal of holding brokers to a higher standard.[129] Indeed, the application of a fiduciary duty in Massachusetts was enacted as a means of bolstering the very protections believed to be lacking in Regulation BI.[130] A victory in Massachusetts could accordingly inspire other states to pass more stringent requirements, or in the alternative, to classify a broader swath of actions taken by brokers as recommendations. In the absence of federal reforms, these state actions could obviate any perceived shortcomings by the SEC. Regardless of which approach, if any, states choose to employ, the parameters of Regulation BI and its progeny will likely be tested by Robinhood and similarly-situated brokers as they increasingly rely on algorithms and personalized data.[131]

V. CONCLUSION

Robinhood has experienced tremendous success since its inception just a short eight years ago. Serving as a pioneer in commission-free trading, Robinhood drew into its fold a wide range of customers from different backgrounds, many of whom had been previously shut out from the trading markets. For this achievement, it can be said that Robinhood has taken steps towards fulfilling its mission of democratizing finance for all. Nonetheless, its meteoric rise and its

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127. *Id.* at *7 (finding that a new customer who had not previously traded was routed to a list of top moving stock after receiving and clicking on the following message: "Top Movers: Choosing stocks is hard. [flexing bicep emoji] Get started by checking which stock prices are changing the most.").

128. Miriam Rozen, *States Line up Behind Mass. Regulators in Targeting Robinhood*, ADVISORHUB (Sept. 20, 2021), https://www.advisorhub.com/states-line-up-behind-mass-regulators-in-targeting-robinhood/.

129. Smith, *supra* note 113.

130. Justin Bauer & Jason Zweig, *After Courts Kill a Federal Fiduciary Rule, Massachusetts Launches Its Own*, WALL ST. J. (Feb. 21, 2020, 3:25 PM), https://www.wsj.com/articles/after-courts-kill-a-federal-fiduciary-rule-massachusetts-launches-its-own-11582311348.

131. *Kick off the New Year with First Trade Recommendations*, ROBINHOOD, https://blog.robinhood.com/news/2022/1/3/kick-off-the-new-year-with-first-trade-recommendations (last visited Feb. 21, 2022)(stating that Robinhood introduced a service for new investors that offers personalized recommendations).

role in high-profile trading scandals have also drawn the attention of regulators and investors critical of some of the broker's practices.

While some of Robinhood's business strategies could be more stringently regulated to enhance consumer protections, enacting such changes would probably present difficult challenges. Any reforms likely to arise from recent events will probably come in the form of updated broker-dealer duties given the appetite for such changes. None of these new regulations are likely to significantly imperil Robinhood, though they may require foregoing certain problematic business tactics. Changes to existing regulations could simultaneously improve transparency issues and allow broker-dealers to continue providing services for those most reliant on them. Democratizing finance for all might be improbable after reforms are enacted, but it can nevertheless continue to serve as a goal worth pursuing.