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NEWS ALERT

SECURITIES GROUP

Robinhood and the Terrible, Horrible, No Good, Very Bad Week

By Mark J. Tarallo | December 23, 2020

On December 17, 2020, the United States Securities and Exchange Commission (the "SEC") announced that a fine of $65,000,000 had been assessed against Robinhood Financial, LLC ("Robinhood"), a leader in the FinTech industry. The SEC also announced that Robinhood had agreed to the entry of a cease-and-desist order (the "Order") against it prohibiting certain practices—including, most notably, failing to adequately disclose "order flow" payments—going forward. This SEC action was just a part of a challenging week for Robinhood, which found itself on the receiving end of an Administrative Complaint filed by the Massachusetts Securities Division on unrelated matters (covered here by my colleague Anthony Leone).

Robinhood was founded in 2013 and began offering retail brokerage accounts to the general public in March 2015. Robinhood distinguished itself from other retail-oriented broker-dealers by, among other things, allowing customers to place orders to buy and sell securities without paying a trading commission. Robinhood offers these self-directed securities brokerage services to customers by means of its website and smartphone applications. Robinhood is an SEC-registered broker-dealer and a member of FINRA.

In the Order, the SEC noted that since Robinhood's launch, payment for order flow has been Robinhood's single largest source of revenue. Rule 10b-10(d)(8) of the Exchange Act defines "payment for order flow," to include any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker-dealer in return for the routing of customer orders. Like other broker-dealers, Robinhood has received payment for order flow in exchange for routing its customer orders to principal trading firms. SEC rules permit the receipt of payment for order flow by broker-dealers as long as it does not interfere with their efforts to obtain best execution, and as long as the routing of that order flow, as well as a description of all terms of any such arrangements that may influence the broker-dealer's order routing decision, are disclosed in quarterly reports filed pursuant to Rule 606.

However, the SEC found that from 2015 through September 2018, certain of Robinhood's retail communications failed to disclose its receipt of payment for order flow. In addition, in FAQs on its website describing how it made money, and in certain communications with customers addressing the same issue, Robinhood omitted payment for order flow when it described its revenue sources because it believed that payment for order flow might be viewed as controversial by customers. Robinhood also instructed its customer service representatives not to mention payment for order flow in responding to questions about Robinhood's sources of revenue. Robinhood's customer agreements and trade confirmations only stated it "may" receive payment for order flow, and Robinhood disclosed *certain* information about those payments in its SEC-mandated Rule 606 reports.

In addition to the failure to disclose the payment for order flow arrangements adequately to customers, the SEC found that Robinhood received unusually high payment for order flow rates, failed to conduct rigorous reviews of execution quality, and delivered poor execution quality to customers. Among other issues, the SEC found that between October 2016 and June 2019, certain Robinhood orders lost a total of approximately $34.1 million in price improvement compared to the price improvement they would have received had they been placed at competing retail broker-dealers, even after netting the approximately $5 per-order commission costs those broker-dealers were charging at the time.

The SEC's enforcement action against Robinhood should serve as a warning to both traditional and FinTech financial services firms. The SEC's focus on Robinhood's customer facing marketing materials make it clear that any failure to fully and completely

disclose compensation arrangements creates a risk for financial service firms; as the SEC noted, Robinhood had complied in *many* respects with compensation disclosure requirements, but they didn't comply with *all* of them. Firms should carefully review their marketing materials, FAQs, and any other customer facing documents to ensure strict compliance with disclosure requirements.

Further, firms should engage in robust internal reviews of policies and procedures, and take immediate action if those reviews show any weakness in compliance. The SEC found that an internal Robinhood review "conducted in October 2018 and March 2019 showed that Robinhood's execution quality was worse than that of other large retail broker-dealers in many respects." However, Robinhood took no action to correct this, and the SEC cited this failure to act in particular due to Robinhood's extensive marketing of commission-free trading and superior execution.

The Order can be found here.

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