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Robinhood Drama Puts Trade Settlement Time In The Spotlight

By **Dean Seal**

Law360 (February 25, 2021, 3:47 PM EST) -- The stock trading war that led Robinhood Markets Inc. to restrict purchases of GameStop Corp. and other so-called meme stocks last month has rapidly renewed interest in shortening trade settlement times, to the apparent delight of the embattled online trading platform.

The Depository Trust & Clearing Corp., which provides clearing and settlement services for U.S. stocks, released a report Wednesday calling for the settlement cycle on securities trades to be reduced from two days to one, arguing that the move would drive down costs, reduce market risks and lower margin requirements.

Murray Pozmanter, head of the DTCC's clearing agency services, said Wednesday that the proposal came after a year of collaboration with major industry players.

But it also notably comes on the heels of **a heated hearing** before the House Financial Services Committee last week in which Robinhood CEO Vlad Tenev testified that his company was forced to restrict buying for GameStop and other **explosively volatile securities** on Jan. 28 because it was unable to meet a $3 billion margin call from a DTCC subsidiary.

Tenev has insisted, both before Congress and in a blog post in early February, that the two-day settlement cycle is to blame for the hefty margins required by clearinghouses and resulting trading restrictions that have landed the popular trading app in hot water **with customers and lawmakers**.

He is calling for a move to real-time settlements, in which trades are processed instantaneously. While the DTCC's proposal doesn't go that far, Tenev said Wednesday that the prospect of a one-day cycle is "a welcome steppingstone to real-time settlement."

"We look forward to working with lawmakers, regulators and the industry to make this a reality," he said in a statement.

The concept of moving to a one-day settlement cycle, which comes after similar transitions from a three-day cycle in 2017 and a five-day cycle in 1995, has been kicked around for years, according to the Cato Institute's Jennifer Schulp, who also testified at last week's congressional hearing. But Schulp says the recent Robinhood saga and the intense publicity it has drawn have put the settlement cycle issue front and center.

"This situation has been an impetus for talking about making that change more quickly than it may have if just left to the industry and regulators' regular processes," Schulp told Law360.

By reducing the amount of time it takes for a trade to settle — meaning that the buyer has received the stock and the seller has received the payment — clearinghouses face less risk of default from either party in the transaction, and thereby require less margin from brokerages to cover those risks, according to proponents of the shift.

And those proponents seem to be springing up all over the place, at least in the wake of the

GameStop trade war. On Monday, U.S. Securities and Exchange Commission member Hester Peirce said in a speech that reducing the settlement cycle further would indeed lower risks and reduce collateral demands, and a day later her former boss at the SEC, Jay Clayton, similarly said in an interview that "the time has come" to shorten the settlement cycle.

"It's amusing to see that former Chairman Clayton is now on board with reducing settlement times, just weeks after leaving a job that he held for four years where he could have done something about it," Healthy Markets CEO Tyler Gellasch told Law360.

Clayton's comments came during a panel hosted by The New York Times' Andrew Ross Sorkin that also included Tenev, who continued to claim that his company's controversial buying restrictions were a result of a system in need of fixing. But Gellasch said he is skeptical about Tenev's motivations, saying that while shortened settlement times are a good thing, Robinhood has used the issue as a "sideshow" to distract from its own failings on Jan. 28.

"Shortening the settlement cycle will reduce systemic risks, particularly in times of volatility, but it had nothing to do with what happened to Robinhood," Gellasch said. "It's not surprising to anybody that a clearinghouse would make margin calls during extreme volatility and heavy trading. What's surprising and disappointing is that Robinhood doesn't seem to have been prepared to back up its own customers' trading."

According to Gellasch, last month's buying restrictions actually stem from Robinhood's own business model of giving millions of customers access to "complex, risky products" and incentivizing "large numbers of small, extraordinarily high risk trades" without necessarily having the capital to back them up.

Robinhood's trading blackouts allowed it to negotiate DTCC's margin call down to $700 million, and the company soon raised $3.4 billion to protect against similar volatility events, but Gellasch said no one should bet on that feat being repeatable.

"If this attempted distraction by Robinhood is the impetus needed to finally shorten the settlement cycle, that's a happy accident, but that is in no way materially addressing the problems that Robinhood or their customers faced," he told Law360.

Robinhood declined to comment on Gellasch's criticisms.

The move to a one-day settlement does, at least theoretically, appear to be a boon for Robinhood and other brokerages, as it would reduce risk in the system, which "clearinghouses passed onto Robinhood by requiring them to deposit additional capital" on Jan. 28, said Jill Fisch, a professor of business law and co-director of the Institute for Law and Economics at the University of Pennsylvania Law School.

But it is unclear whether it would have saved Robinhood from having to curb trading in late January. The Cato Institute's Schulp told Law360 that a one-day settlement cycle could have resulted in lower collateral requirements, but whether Robinhood would've been able to meet even that standard on Jan. 28 "is a much more difficult question to answer."

Robinhood's own recent advocacy around the shortening of settlement times has never focused on one-day settlement cycles but rather on settling trades instantaneously, which industry experts broadly agree would require an extensive overhaul of the modern financial system.

Peirce said in her speech Monday that the buffer time built into the current settlement cycle allows for counterparties to correct errors or intervene on trades as needed, and that moving to instant settlements could raise costs for market makers, like Citadel Securities, who are essential in providing liquidity to the market.

The DTCC's report on Wednesday similarly lists a number of barriers to using real-time settlements and states that transitioning to a one-day cycle would reduce the volatility component of current margin requirements for brokers by 41%, without requiring "large operational or technical changes by market participants."

That said, the proposal reports that DTCC's clients consider real-time settlements "very appealing in theory and aspirational in nature," and Peirce pointed out that recent innovations, like smart contracts and blockchain technologies, "could make the entire clearing and settlement process in the equity markets faster and more efficient."

John Berlau of the Competitive Enterprise Institute echoed the notion that real-time settlements carry many benefits but would require a costly transition process for the financial system. He suggested that the SEC try to implement pilot programs for real-time settlements "while not forcing those market participants who are comfortable with the T+2 system to immediately abandon it."

"With data gathered from the pilot program, the SEC would have more knowledge on which to base an ultimate solution," Berlau told Law360. "I believe the ultimate solution should also, to the extent it can, allow both investors and brokers to choose the type of settlement system they feel serves them best."

--Editing by Brian Baresch.

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