Robinhood, Reddit, Citadel Defend Their Actions Before Congress

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Feb 19, 2021

The Committee on Financial Services of the United States House of Representatives held a virtual hearing on Feb. 18, 2021, with the title "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide." The announcement for the hearing noted that "recent market volatility involving GameStop [Corporation (GME)] stock and other stocks" would be the focus of the hearing.[1]

In a statement released on Jan. 28, 2021, in the wake of the GameStop stock trading controversy, Representative Maxine Waters, D-Calif., who chairs the committee, expressed particular concern about hedge funds, "predatory short selling," "private funds engaging in vulture strategies," and gamification. Later on, the committee memorandum released in advance of the meeting raised concerns about payment for order flow (PFOF) and best execution obligations.[1]

The following summary is based on the hearing from its start at 12 noon Eastern Time to a recess at 4:19 PM, by which time most of the members of the committee had spoken.[2]

- The Committee on Financial Services of the U.S. House of Representatives held a hearing on the GameStop affair and related matters on Feb. 18, 2021.
- Robinhood CEO Vlad Tenev defended practices such as payment for order flow, as did Kenneth Griffin, CEO of Citadel, a major recipient of that order flow.
- Tenev asserted that the vast majority of Robinhood users are long term investors, while only small minorities engage in riskier trading.

Partisan Divide

The questions and comments from the committee generally broke along partisan lines. For the most part, Democrats voiced negative views of payment for order flow, and were skeptical about the benefits of the so-called "democratization of investing," whereby platforms such as Robinhood have spurred a surge in trading by retail investors.

Representative Jim Hines, D-Conn., even likened the financial markets to a "casino" in which institutions represent the house, and regularly take advantage of unsophisticated individual investors who are viewed by the financial industry as "dumb money." Later on, Representative Steve Stivers, R-Ohio, opined that his Democratic colleagues were trying to "drive a narrative about U.S. capital markets being rigged."

Stivers' comment drew a rebuke from Chairwoman Waters, who saw this as an attempt to "impugn" the motives of members from her party. Meanwhile, several Democratic members saw an irony in Robinhood's name, suggesting that the firm is taking from small investors to give to bigger players in the markets.

Republican members tended to hail the "democratization of investing," see no major issues with payment for order flow, and believe that a rush to draft new legislation would be inadvisable. Representative Ann Wagner, R-Missouri, said that she sees "good in lower account minimums and zero commission trading." She added, "Congress should reduce barriers to market participation by ordinary Americans," and stated that she is "against new federal regulatory burdens with barriers to entry."

Similar views to the Republicans were voiced by Jennifer Schulp, Director of Financial Regulation Studies at the Cato Institute, a think tank that favors free enterprise and limited government. She formerly was an enforcement attorney at FINRA.

The GameStop Controversy

Vlad Tenev, CEO of online brokerage firm Robinhood Markets, Inc., issued a flat denial that his firm decided to limit trading in GameStop and other stocks based on his firm's business ties to investment firms that were caught in short squeezes on these stocks. Rather, he said that Robinhood restricted purchases (but not sales) of these stocks in response to collateral requirements imposed by its clearinghouse, the NSCC, a subsidiary of the DTCC. He also said that other brokerages instituted similar trading limitations.

Jennifer Schulp of the Cato Institute discussed the matter later on, indicating that the T+2 settlement period presents a risk of non-settlement, and that brokerage firms must have access to adequate collateral to mitigate this risk. In response to an even later question, she noted that the Dodd-Frank Bill was the source of the capital requirements at issue.

Earlier on, Schulp called the GameStop event "a typical market imbalance" and saw no need for legislation. Similarly, Tenev described the GameStop affair as a "five-sigma," "black swan," or "one in 3.5 million" event.

Representative Carolyn Maloney, D-NY, criticized Tenev for a "lack of candor" regarding the GameStop affair, given that he did not disclose collateral requirements as a reason at the time. "Your trading restrictions came out of the blue," she added. Tenev responded by admitting mistakes and promising to improve in the future.

Payment For Order Flow

Representative Brad Sherman, D-Calif., expressed concerns that, in contrast to commissions, which are "in the open," payment for order flow results in worse execution prices for investors, which are not disclosed. He asked Kenneth Griffin, CEO of Citadel LLC, whose market maker division is a major recipient of order flow from Robinhood, whether a Robinhood client gets the same price as a major institution like Fidelity. Sherman demanded a simple yes or no answer, and Griffin attempted a longer explanation, indicating that "channels matter" and allowing that the size of the trade is a factor. Annoyed, Sherman accused Griffin of filibustering.

Later on in the hearing, Griffin asserted that his firm offers better execution than the exchanges, which is why Citadel gets order flow. He cited regulatory rules that require the exchanges to maintain a bid-offer spread of at least one cent, which can be artificially wide on low-priced stocks. By contrast, his firm can quote spreads of less than one cent. Moreover, he indicated that orders from Robinhood are much smaller than most trades executed on the exchanges, and thus present less risk, though he was unclear on how this influences his firm's pricing.

Yet later, Griffin stated that regulations should be altered to make exchanges more competitive, rather than limiting the activities of non-exchange market makers such as so-called dark pools.

For his part, Tenev said that "Citadel offers superior execution quality," and that Robinhood automatically will route trades away from Citadel if other market makers offer better execution. Tenev also noted that Robinhood has a policy of accepting the same payment for order flow from all market makers, to eliminate conflicts of interest. Additionally, he observed that, while Robinhood charges no commissions because it is paid for order flow, it is common for other brokerage firms to receive both sources of revenue simultaneously, on the same trades.

Jennifer Schulp of the Cato Institute said that payment for order flow has driven positive innovations in the markets. Nonetheless, she also indicated that more disclosure would be good.

Long Term Focus of Robinhood Investors

In response to a suggestion by Representative Gregory Meeks, D-NY, that Robinhood encourages risky investing practices, Tenev offered these statistics on his customers: only 2% buy on margin, only 14% trade in options, only 3% trade in multi-leg options, but most are "long term buy and hold investors."

Tenev noted that the rules on margin trading are industry-wide, but asserted that his firm is more restrictive. Specifically, he said that only Robinhood Gold customers, who pay a $5 monthly fee, may trade on margin. Later on, he also indicated that, as a group, Robinhood's clients have over $35 billion in unrealized gains in their accounts.

Representative Cindy Axne, D-Iowa, expressed concerns over practices that she sees as encouraging excessive trading. Tenev said that Robinhood simultaneously seeks to "give people what they want in a responsible way" and is against the gamification of investing.

The Role of Reddit

Much of the trading frenzy in GameStop originated in posts on Reddit. CEO Steve Huffman of Reddit said that his company takes measures to ensure that its platform is not used for manipulation. However, the Wall Street Bets forum allows users to conceal their real identities, which he defends as a means for people to discuss their personal finances without revealing personal information.

Representative David Scott, D-Georgia, opined that it would be a "serious threat to the financial system if tweets and posts do more to move stocks than material information." In this vein, he asked if Robinhood monitors social media. Tenev said: "We don't do it. We don't have the data to tie posts to identities."

Scott also asked if Robinhood monitors whether clients trade on good information, rather than on rumor. Rather than discussing whether this actually can be done, Tenev instead spoke about the Robinhood Learn Portal, a free educational resource that can be accessed by anyone, not just clients.

Representative French Hill, R-Ariz., asked Jennifer Schulp of the Cato Institute whether the SEC should investigate the possibility that Wall Street Bets is regularly used to disseminate deceptive or manipulative information. She believed that the SEC should look into this, though she sees no evidence for it.

In response to questions about whether the enactment of a tax on transactions would be a positive policy response designed to deter excessive trading, Tenev, Griffin, and Schulp each replied in the negative. They all noted that the ultimate effect would be to raise costs and reduce investment returns for ordinary retail investors and savers, including beneficiaries of pension funds, while also impeding the free flow of capital. While none of them used this terminology, the upshot of their comments was that such a tax would create a net deadweight loss for the economy.