MarketWatch

# Robinhood-GameStop saga could put spotlight on DC, Wall Street revolving door

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**Robinhood has hired several former regulators in recent months**

As the financial services industry prepares for congressional scrutiny in the coming weeks following the public outcry related to online broker Robinhood's decision to restrict trading of GameStop Inc. **GME, -12.25%** and other stocks, the perception of a cozy relationship between financial regulators and the industry could once again come to the fore.

Of particular interest will be regulators' lack of action in recent years in reforming market structure issues — including payment for order flow, or the practice of market makers paying stockbrokers to route customer orders to them — as many of the former regulators responsible for such reforms are now working for firms in the industry that engage in and profit from the practice.

"We've had festering problems for 12 years now of not addressing, acute, pressing market structure issues," said James Cox, law professor at Duke University, who specializes in corporate and securities law.

Cox said the Securities and Exchange Commission and the Financial Industry Regulatory Authority should have done more in recent years to significantly rein in the practice of payment for order flow and to set new rules about the types of orders market makers and stock exchanges can accept from traders that can give them informational advantages over individual investors.

Robinhood earned more than $190 million in revenue from payment for order flow in the fourth quarter of 2020, according to regulatory filings and made more such revenue per trade than competitors like E-Trade and Charles Schwab. Robinhood did not respond to requests for comment.

Government watchdogs have long decried the practice of regulators leaving government to work for companies they once regulated, and Robinhood has been one of the most aggressive deployers of this tactic in recent months, hiring former SEC Commissioner Dan Gallagher to be its chief legal officer last May.

In addition to Gallagher, the broker has recently brought on other SEC alums Lucas Moskowitz and Janet Broeckel, according to LinkedIn. It also brought in Andrew Ceresney, who served as the SEC's director of the division of enforcement from 2013 to 2017, as outside counsel to help it settle charges that it misled investors about the practice of payment for order flow and that it cost investors $34.1 million by failing to execute trades at the best price.

Robinhood settled the matter after paying a $65 million fine, without admitting nor denying fault. The company said in December that "the settlement relates to historical practices that do not reflect Robinhood today" and that it is now fully transparent with customers about its revenue streams and vigilant about getting them the best prices on securities.

"Firms understand that their business model requires a soft touch from regulators, and the best way to ensure that is to have financial connections with regulators associated with both political parties," said Jeff Hauser, executive director of The Revolving Door Project, which aims to track corporate political influence.



Citadel Securities, which paid more to Robinhood for order flow than any other firm in the fourth quarter of last year, has also been a landing place for former regulators. Stephan Luparello, former director of the trading and markets division, which oversees market structure issues, served as its general counsel since 2017. Citadel declined to comment for this article.

Market structure issues, including payment for order flow, were last in the public spotlight in 2014, when former Democratic Sen. Carl Levin of Michigan held hearings on it and recommended regulators ban it.

Regulators have made some reforms since then, with the SEC requiring brokers to provide greater disclosure of payment to order flow revenues, while Finra has stepped up enforcement against brokers who do not regularly analyze their orders to make sure customers, on average, get the best price and execution of their orders.

But critics say they have not gone far enough, and that payment for order flow is a byproduct of a system of wasteful competition between market makers for information and faster access to the major stock exchanges.

Peter Van Doren, a senior fellow at the Cato Institute and editor of the journal Regulation, told MarketWatch that "the payments for order flow is part of this high-frequency trading system where there's an arms race" to build faster trading systems ever closer to the major exchanges, in order to arbitrage slight differences in market prices and those listed on exchanges.

He pointed to a study of activity on the London Stock Exchange, which showed that if market makers didn't have to engage in this competition, they'd be able to provide prices that save investors $5 billion globally every year.

Other experts, however, say that the lack of action on payment for order flow was simply because it's not clear the practice harms individual investors. Indeed, the cost of individual trades and bid-ask spreads have come down dramatically in the thirty years that this practice has been around, Gabriel Rauterberg, an expert on capital markets at Michigan Law told MarketWatch.

"It's seems deeply weird that if you're a retail trader, your order doesn't go to a stock exchange, but that your broker gets paid to send it to a market maker," he said, but added that this appearance of corruption is not backed up by evidence of retail traders being cheated on a large scale.

Instead of regulators moving to ban the practice, which would cause widespread, costly disruption to the entire industry, regulators could mandate that brokers pass on all payment for order flow to their customers through price improvement, Rauterberg proposed.

“Education doesn’t seem to alter people’s sense that there’s something unseemly about this,” he said. “Eliminating the appearance of a conflict of interest would go a long way for investor confidence.”