CARLTON FIELDS

Regulators Consider Payment for Order Flow and the Gamification of Trading After GameStop

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The U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) have been busy of late in efforts to address alleged compliance issues associated with payment for order flow (PFOF), gamification of trading, and the consequences of the trading halt in GameStop last January. Robinhood has been a central figure in this drama, settling three SEC and FINRA matters in the past two years for more than $136 million, collectively, and remains a focus of regulatory action and numerous class action lawsuits following GameStop. Here is what broker-dealers need to know about PFOF and gamification under the current regulatory framework and what to expect after GameStop.

Backstory

Payment for Order Flow: The SEC defines PFOF broadly to encompass "'a wide variety of cash or in-kind compensation structures that a broker may receive for directing its customers' orders to a particular broker-dealer or trading venue.' Given its broad definition, payment for order flow may refer to, among other things, arrangements where retail brokerage firms receive cash payments from wholesale market makers in exchange for customer order flow, as well as transaction fee rebates, credits, or discounts provided by exchanges." As such, the SEC has stated that PFOF may provide an economic incentive that can potentially influence a firm's order handling.

Further, long-standing SEC guidance holds that receipt of PFOF does not constitute a per se violation of a firm's best execution obligations but does raise concerns about best execution. Simply put, a broker-dealer "must not allow a payment or an inducement for order flow to interfere with its efforts to obtain best execution."

PFOF has been in existence — and controversial — since at least the 1990s. Criticism then and now centers around the potential conflict of interest between a firm maximizing its PFOF and providing best execution to customers. In November 2015, FINRA published Regulatory Notice 15-46 to

reiterate the best execution obligations of member firms in light of increasingly automated markets and advances in trading technology and communications, including PFOF. On June 23, 2021, FINRA published Regulatory Notice 21-23 specifically reminding firms of their best execution obligations in the context of PFOF.

Firms also are required to disclose PFOF arrangements to their customers. Under the Exchange Act, firms must provide written notification to customers at or before completion of a transaction that PFOF is being received and that the source and nature of the compensation will be furnished upon request. Firms are further required by Reg NMS to make publicly available each calendar quarter a report on the member's routing practices to include, among other things, the net aggregate amount of any PFOF received, both as a dollar amount and per share, and a description of any arrangement for PFOF.

Gamification of Trading: "Gamification" is a relatively recent term and refers to "the process of adding games or gamelike elements to something (such as a task) so as to encourage participation." Gamification of trading began with the use of website and mobile phone apps with interactive and game-like features, behavioral prompts, and advertising alleged to encourage more trading. It is typically commission-free and thus may appear to be free to users. According to the SEC, certain of these apps attract as much as 40 times the order flow of other platforms and, in the case of options trading, as much as 88 times.

Robinhood

Robinhood Financial LLC is an introducing broker-dealer that uses both PFOF and gamification to provide commission-free trading to retail customers through its website and mobile apps. According to FINRA, "[s]ince launching its online trading platforms in December 2014, Robinhood has quickly attracted customers — many of whom are relatively young and new to investing — including through offerings such as no-minimum, commission-free trading and a user interface 'designed to ... appeal to a new generation of investors who are more comfortable trading on smartphones.' Through these and other initiatives, Robinhood has experienced dramatic growth — from fewer than 500,000 customers in 2015 to over 31 million today."

As the leading pioneer in such trading, it is not surprising that Robinhood has also been the subject of regulatory interest. In the last two years, Robinhood has agreed to three settlements with fines aggregating more than $136 million that highlight potential compliance issues associated with a PFOF and gamification trading model:

- **2019 FINRA Acceptance, Waiver, and Consent (AWC):** In December 2019, Robinhood accepted and consented (without admitting or denying the findings) to the entry of findings by FINRA that, from October 1, 2016, to November 9, 2017, the firm violated FINRA best execution and supervision rules by not exercising reasonable diligence to ascertain that the broker-dealers to which it routed customer orders for PFOF provided the best execution quality as compared to other execution venues and by not having a reasonably designed supervisory system and procedures to achieve compliance with its best execution obligations. The firm consented to a $1.25 million fine and an undertaking to retain an independent consultant to address compliance with best execution requirements.
- **2020 SEC Offer of Settlement:** In December 2020, Robinhood consented (without admitting or denying the findings) to findings that, from 2015 to June 2019, the firm violated its duty of best execution to customers in maximizing the firm's PFOF, omitted material information about PFOF on its website and in communications to its customers, and made material misstatements about the execution quality it achieved for customers' orders, in violation of federal anti-fraud rules, and that it did not maintain required records, in violation of federal bookkeeping rules. The firm consented to a $65 million fine and an undertaking to retain an independent consultant to conduct a comprehensive compliance review regarding firm policies, procedures, and training to ensure that the firm's retail communications and disclosures comply with the requirements of the federal securities laws and that the firm's PFOF arrangements are not interfering with the firm's duty to obtain best execution for their customers.
- **2021 FINRA AWC:** In June 2021, Robinhood accepted and consented (without admitting or denying the findings) to the entry of findings by FINRA that, since September 2016, the firm provided false and misleading information to customers, failed to exercise due diligence in approving options accounts, failed to reasonably supervise technology critical to its core functions leading to serious outages between 2018 and 2020 (most seriously in March 2020), failed to create a reasonably designed business continuity plan, failed to report customer complaints to FINRA, failed to have a reasonably designed customer identification program, and failed to display complete market data information. In imposing sanctions, FINRA considered, among other things, that the firm, "over a period of at least five years, failed to establish and maintain a supervisory system that was reasonably designed to achieve compliance with FINRA rules and applicable securities laws and regulations, and as a result, experienced systemic supervisory failures in several critical parts of its business." The firm consented to a $57 million fine, the largest in FINRA's history, and restitution of approximately $12.6 million, plus interest.

The lessons from the settlements are clear: broker-dealers who choose a PFOF and gamification trading model are at risk for heavy fines if they do so without first establishing systems and procedures to address their best execution obligations and the need for adequate regular and rigorous review of execution quality. Further, they would be best served by implementing robust systems and procedures to address the many potential compliance issues associated with a rapid

increase in order flow, including the areas of customer identification, options account approval, communications with customers, display of information, disclosures, core trading technology, business continuity plans, and the handling of complaints. Finally, they also should establish a supervisory system and written procedures that are reasonably designed to achieve compliance with all such requirements.

GameStop

In January 2021, a short squeeze of GameStop (GME) and other securities took place in which institutional investors sold short GME to such an extent that the shares sold represented 140% of the public float. Instead of the price dropping, however, certain internet message boards such as the "WallStreetBets" Reddit forum, aware of the extremely high short interest, helped drive the price of GME up 17-fold over a few weeks. According to media outlets, the short squeeze was unusual in that it was energized by social media and facilitated by gamification on platforms such as Robinhood, which primarily support individual investors. But as the price peaked, Robinhood and other broker-dealers halted customer purchases of GME and other volatile stocks. Trading restrictions were gradually eased over the following days.

Public outrage at the trading halt was immediate. But as the reason behind the trading halt became clear — newly imposed collateral requirements for clearing and settlement purposes that exceeded the firm's available net capital — attention turned to whether the trading halt was implemented fairly and whether moving to T+1 (or T+0) clearing would be feasible to reduce the clearinghouse's exposure to risk with a commensurate reduction in required collateral requirements and, presumably, any future trading halts.

Lawsuits against Robinhood were filed almost immediately in federal and state courts. There are now approximately 50 class action lawsuits arising from the GameStop trading halts, approximately 15 arising from the outages of March 2020, and approximately a half-dozen arising from its use of PFOF.

The GameStop Investigation

Beginning in February 2021, the House Financial Services Committee conducted hearings on the GameStop market events, to include addressing congressional concerns regarding PFOF and the gamification of trading:

- **Robinhood CEO Vlad Tenev** testified on February 18, 2021, regarding Robinhood's zero-commission, PFOF trading model and its benefits to customers; that their app was designed to appeal to a new generation of investors who were more comfortable trading on smartphones than speaking to a broker, but that the app was not a game; and that informing and supporting customers was a firm focus.

- Tenev then testified regarding the trading halt, stating that, beginning the week of January 25, 2021, the firm's NSCC collateral clearing fund requirement was $124 million but that NSCC raised the requirement to $3.7 billion the morning of January 28, far above the firm's available net capital. As a result, Robinhood imposed trading restrictions on GME and other securities. Later that morning, the collateral requirement was reduced to $1.4 billion by NSCC and Robinhood raised additional funds to meet the obligation. The firm continued to raise funds to meet future potential collateral requirements and gradually removed the trading restrictions.
- Tenev also testified regarding the present T+2 trade settlement period, arguing that it "exposes investors and the industry to unnecessary risk and is ripe for change" and that the industry should move to real-time settlement (i.e., T+0) for U.S. equities.
- **Reddit Trader Keith Gill** (aka "Roaring Kitty") also testified on February 18. The apparent leader of the young Reddit traders, Gill asserted that he was simply an investor and believed GME was undervalued, that he had no inside information, and that he did not solicit anyone to buy or sell the stock for his own profit.
- **Citadel Securities Founder Kenneth Griffin** also testified on February 18, asserting that Citadel Securities, as a market maker, adhered to its obligations during the market events, providing liquidity despite unprecedented demand. Griffin also expressed dissatisfaction with the T+2 settlement period, advocating shortening the settlement period to T+1.
- **Melvin Capital Management Founder and Chief Investment Officer Gabriel Plotkin** also testified on February 18, asserting that Melvin, a hedge fund specializing in the consumer and technology sector, had shorted GME for the past six years because it believed that GameStop, selling video games in physical stores, was overvalued and especially so following significant losses in 2020. As a result of the buying frenzy, however, Melvin lost more than 50% on its investments.
- **Depository Trust & Clearing Corp. (DTCC) President and CEO Michael Bodson** testified on May 6, 2021, detailing the essential role of the DTCC and NSCC, the T+2 clearing process, clearing fund requirements, and the January 2001 market events. He also described recent DTCC efforts to explore the benefits of moving to a T+1 or T+0 settlement cycle, including new technologies and models that could be employed that would result in lower margin demands at NSCC. He referenced a DTCC white paper published in February 2021 outlining several steps it was exploring with the industry regarding accelerated settlement for equities transactions, recommending it be accomplished within three years. Doing so, he stated, could save clearing members upwards of $6 billion per day in margin requirements during periods of extreme volatility.
- **FINRA CEO Robert Cook** also testified on May 6, 2021. Cook first lauded the benefits of innovations in the industry and then emphasized the need for regulators, in light of such innovations, to continually review applicable standards and consider whether they ought to be updated to better protect investors and promote market integrity.

- Cook then detailed the focus of ongoing FINRA investigations into GameStop: an internal working group to review member firm conduct during the recent market events and a review of order routing practices, where PFOF is involved, to assess compliance with order handling and best execution rules both during the market events and more generally. He reiterated SEC guidance regarding PFOF, that it is permissible provided it does not interfere with best execution. He added that FINRA would support any SEC efforts to consider enhancements to the disclosure obligations that help support the oversight of best execution. He also addressed gamification and app-based brokerage services, reiterating FINRA's rules against false, exaggerated, or misleading statements in firm communications no matter the means used and emphasizing that the use of gamification-type features must be carefully evaluated to ensure they meet all applicable regulatory obligations, including whether the use of a feature may constitute a recommendation under Reg BI.

- Cook ended his remarks by stating that, because of the growing prevalence of gamification features, FINRA is evaluating whether additional rulemaking or guidance may be necessary to ensure their use is consistent with investor protection. The next step would be for FINRA to publish a regulatory notice seeking additional information on the use and impact of gamification or, alternatively, to support any SEC request for comment on these developments. Further, he testified that FINRA was considering whether changes to the options rules may be warranted, given the role of options trading in the recent market events by retail investors who may have opened accounts to trade options without, he said, fully appreciating the risks involved.

- **SEC Chair Gary Gensler** also testified on May 6, 2021. Gensler noted that the recent events were but "part of a larger story about the intersection of finance and technology." He stated that he expected to publish a staff report assessing the past market events in the next few months to review potential violations and to consider whether expanded enforcement mechanisms are necessary.

- With respect to PFOF, Gensler acknowledged that most retail broker-dealers have stopped charging fees for trades, instead turning to other streams of compensation, including PFOF. He raised several concerns regarding PFOF, including whether there was an inherent conflict of interest, whether customers were getting best execution, whether broker-dealers were incentivized to encourage customers to trade more frequently than is in their best interest, and whether there were policy implications regarding the aggregation of data by purchasers of the order flow.

- With respect to gamification, Gensler expressed concern about protecting investors from features on trading apps that may encourage them to trade more, which may result in lower returns, on average, and may be contrary to Reg BI. He has asked his staff to prepare a request for public input for consideration on these issues. In addition, Gensler indicated there is a need to evaluate current rules given that they were largely written before these new technologies became prevalent.

- Also relevant are Gensler's comments regarding the intersection of social media with trading. Gensler noted the rapidly changing face of social media and the opportunities and challenges it poses for the industry. In particular, he noted concern that bad actors might potentially take advantage of influential platforms to manipulate the market. He also noted concerns as to whether broker-dealers were adequately disclosing their policies and procedures regarding potential trading restrictions; whether margin requirements and other payment requirements were sufficient; and whether broker-dealers have appropriate tools to manage their liquidity and risk. Gensler stated his staff will look into these issues.

- Finally, Gensler noted concerns about the current T+2 clearance and settlement process, stating that the longer it takes for a trade to settle, the more risks our markets assume. He concluded:

  > The good news is, though it will take a lot of work by many parties, we now have the technology to further shorten the settlement cycles, not only to the settlement cycle we had a century ago, but even to same-day settlement (T-0 or "T-evening").
  >
  > I believe shortening the standard settlement cycle could reduce costs and risks in our markets. I've directed the SEC staff to put together a draft proposal for the Commission's review on this topic.

What to Expect from Regulators After GameStop

The SEC and FINRA are clearly committed to adapting the existing regulatory regime to new business models and technologies that provide investors better access to capital markets. This commitment means that, even in the aftermath of GameStop, there will not likely be significant limitations or prohibitions against either PFOF or gamification. Instead, expect the following:

- PFOF. While the regulators have not expressed any interest in significantly limiting or prohibiting PFOF, there is interest in continuing to focus on best execution under the PFOF model. This is demonstrated in FINRA Regulatory Notice 21-23, issued on June 23, 2021 (i.e., after GameStop), which provides additional and specific guidance regarding best execution and PFOF. In particular, the notice reiterates that FINRA's best execution rule requires member firms "to compare any material differences in execution quality their customers will receive at competing markets — including markets they may have existing routing arrangements with, as well as those they do not." Thus, expect the PFOF model to continue and that FINRA enforcement, going forward, will continue its focus on best execution and regular and rigorous review of execution quality, to include an assessment of execution quality at competing markets.

- Gamification. The regulators also have not expressed any interest in significantly limiting or prohibiting the gamification of trading. But they are studying the apps to understand their various features and to assess whether their use increases risk for investors; encourages trading that is misaligned with investors' objectives, risk tolerance, or best interests; distracts investors from the financial consequences of trading decisions; or constitutes a recommendation regarding a particular trade. Expect FINRA to issue a regulatory notice in the near term to address these alleged issues. The guidance may call for additional disclosures to investors and could curtail the use of particular features. Broker-dealers should scrutinize any features in their apps that could be subject to an argument that they might mislead, encourage or reward trading, or constitute a recommendation and, in addition, broker-dealers should ensure that their disclosures to users specifically detail the risks of such trading.

- Options Trading. FINRA issued Regulatory Notice 21-15 on April 9, 2021 (i.e., after GameStop) to remind members about options account approval, supervision, and margin requirements. FINRA's stated concern was that investors may be opening accounts to trade options and other complex leveraged products in self-directed accounts without fully appreciating the risks involved and without a financial professional to assist. Further, FINRA noted that there are existing due diligence requirements for firms approving customers to trade options, including suitability requirements, disclosure requirements, and specific supervisory requirements. The goals of these requirements include ensuring that options trading is consistent with customers' investment objectives and that reasonable customer identification procedures are used. Notably, *after* GameStop and the issuance of the regulatory notice, FINRA CEO Cook testified that "we are considering whether changes to the options rules may be warranted" as a result of such concern. Thus, expect to see rulemaking in this area.

- T+1 Settlement. Expect acceleration of the move from T+2 to a T+1 or perhaps a T-0 (or T-evening) settlement cycle, which would directly address the reported basis for the GameStop trading halt by reducing the time for settlement, thereby reducing the risk to the NSCC and to firm clearance fund requirements. Both the DTCC and SEC favor such a move.

- Disclosure Requirements. FINRA issued Regulatory Notice 21-12 on March 18, 2021 (i.e., also after GameStop) extensively detailing firm disclosure requirements regarding order routing practices and execution during extreme market conditions. Expect FINRA enforcement to scrutinize such disclosures going forward.

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