WSJ News Exclusive | Robinhood Faces SEC Probe for Not Disclosing Deals With High-Speed Traders

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Robinhood Markets Inc. faces a civil fraud investigation over its early failure to fully disclose its practice of selling clients' orders to high-speed trading firms, people familiar with the matter said.

The investigation is at an advanced stage and the company could have to pay a fine exceeding $10 million if it agrees to settle the Securities and Exchange Commission probe, one of the people said. A deal, however, is unlikely to be announced this month, the people said, and the two sides haven't formally negotiated a proposed fine, the person said.

A Robinhood spokeswoman declined to comment on the investigation or any talks with regulators, but said: "We strive to maintain constructive relationships with our regulators and to cooperate fully with them."

An SEC spokeswoman declined to comment.

The probe is the latest headache for the upstart brokerage firm that was founded in 2013 and has developed a hugely popular app that allows individuals to trade stocks, options and cryptocurrencies without paying any commissions. While Robinhood has seen phenomenal growth this year, the Menlo Park, Calif.-based firm has faced setbacks such as outages that prevented customers from trading, the cancellation of its plans to expand to the U.K. and fallout from the suicide of a 20-year-old Robinhood customer who thought he had lost money from a sophisticated options trade.

Companies that settle SEC investigations often pay fines without admitting or denying misconduct. Any settlement may not accuse Robinhood of intentionally violating the most serious antifraud laws, and instead allege the company should have known its statements were false or misleading, one of the people said.

How Robinhood Is Shaking Up the Brokerage Industry

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As millions of new traders sign up for the investment app Robinhood, the company is facing scrutiny for enabling some inexperienced users to make risky bets. WSJ spoke with a financial education professional and two Robinhood traders about how the app is shaking up the brokerage industry.

The investigation, run out of the SEC's San Francisco office, examined Robinhood's failure to fully disclose on its website—until 2018—that it took payments from high-speed trading firms for sending them customers' orders to buy or sell stocks or options, the people said. The practice, known as payment for order flow, is a common—if controversial—way for retail brokerages to execute client trades. Critics say payment for order flow creates a conflict of interest for the broker that sells the orders. The practice has raised suspicions that it could lead to sophisticated traders exploiting mom-and-pop investors, although brokers and traders say such concerns are baseless.

Until October 2018, Robinhood had a page on its website titled "How We Make Money" that listed only two revenue sources: fees for its margin-trading service and interest collected on customer deposits. It didn't mention payment for order flow, even though the payments to high-speed traders were detailed in regulatory disclosures available elsewhere on the website. The SEC enforces laws that require brokerage firms, public companies and other Wall Street players disclose all material facts that an investor would want to know to make a trading decision.

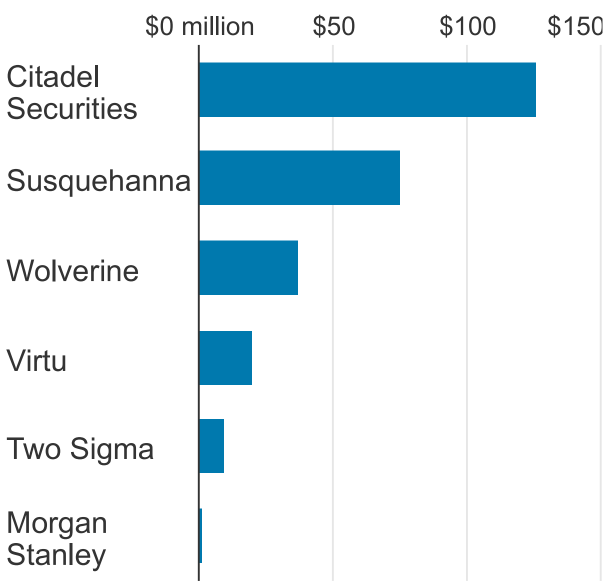
Payment for order flow is legal. It often results in slightly better prices for individual investors, the SEC wrote in a report about algorithmic trading issued last month. The SEC's report said high-speed trading firms pay for access to the orders because they "generally have more information and processing power than retail traders and brokers" and value the opportunity to trade with less informed traders.

Payment for order flow represented a significant portion of Robinhood's revenue at the time. The privately owned startup earned under half of its revenue in 2017 from such payments, and roughly half in 2018, a person familiar with the matter said.

During the second week of October 2018, Robinhood updated its webpage to disclose that it "receives rebates from executing brokers." Also that month, Vladimir Tenev, Robinhood's co-founder and co-chief executive, published a blog post about the firm's payments from high-speed traders. "The revenue we receive from these rebates helps us cover the costs of operating our business and allows us to offer commission-free trading," he wrote.

Total payments to Robinhood from trading firms for routing orders, first half of 2020

Numbers reflect combined payments for both stock and option orders.
Source: Robinhood order routing reports



Robinhood collects payments from trading firms such as Citadel Securities and Virtu Financial Inc. for executing its customers' orders. In 2019, the company paid [$1.25 million to settle regulatory claims] tied to that same practice. The Financial Industry Regulatory Authority, a supervisor of brokerage firms that reports to the SEC, said Robinhood didn't take sufficient steps from October 2016 to November 2017 to ensure it was getting the best prices for customer orders.

Robinhood said this year it has amassed more than 13 million customer accounts, and it was valued at $11.2 billion in a recent funding round. Its trading app has boomed in popularity during the coronavirus pandemic, as more individual investors gamble with stocks and options. Its popularity has put its approach to attracting customers in the spotlight, with some critics saying Robinhood makes it too easy for novice traders to make risky bets.

Brokers and electronic-trading firms say small investors benefit from payment for order flow by getting better prices on their trades than they would get on public stock exchanges like the New York Stock Exchange or the Nasdaq Stock Market. Although the investor might be able to buy a share for just a fraction of a cent less than on an exchange, those better prices add up to billions of dollars of savings for the entire population of small investors, analysts say.

Still, the controversial nature of payment for order flow makes it an awkward topic for Robinhood, which has described itself as a democratizing force in finance that is seeking to upend traditional ways of doing business on Wall Street.

This year, new disclosure reports mandated by the SEC have shed more light on Robinhood's revenues from electronic trading firms. Robinhood made $271 million in such revenues during the first half of this year, the reports show.

Robinhood's co-founders, Baiju Bhatt and Mr. Tenev, both have roots in the high-speed trading world. Before founding Robinhood, they ran Chronos Research, a startup that made software for ultrafast trading firms.

Its products included Zardoz, a trading platform named after a 1974 science-fiction movie starring Sean Connery, and a data tool called Brutalis, which the company touted as "brutally fast" on an archived version of its website.

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Corrections & Amplifications
Before founding Robinhood, Baiju Bhatt and Vladimir Tenev ran the startup Chronos Research. An earlier version of this article incorrectly said Cronos Research. (Corrected on Sept. 2)