****

9B21M057

Robinhood Markets Inc.: BUSINESS MODEL CHALLENGES[[1]](#endnote-1)

Ram Subramanian wrote this case solely to provide material for class discussion. The author does not intend to illustrate either effective or ineffective handling of a managerial situation. The author may have disguised certain names and other identifying information to protect confidentiality.

This publication may not be transmitted, photocopied, digitized, or otherwise reproduced in any form or by any means without the permission of the copyright holder. Reproduction of this material is not covered under authorization by any reproduction rights organization. To order copies or request permission to reproduce materials, contact Ivey Publishing, Ivey Business School, Western University, London, Ontario, Canada, N6G 0N1; (t) 519.661.3208; (e) cases@ivey.ca; www.iveycases.com. Our goal is to publish materials of the highest quality; submit any errata to publishcases@ivey.ca. i1v2e5y5pubs

Copyright © 2021, Ivey Business School Foundation Version: 2021-05-14

After a highly volatile day of trading the stock of GameStop Corp. (GameStop), on January 27, 2021, Robinhood Markets Inc. (Robinhood), the online stock-trading platform based in Menlo Park, California, received a call from Depository Trust & Clearing Corporation (DTCC). DTCC was a clearing house that handled the platform’s trades and they asked Robinhood for a sizable increase in deposits for the next day’s trading.[[2]](#endnote-2) Anticipating similar calls from other clearing houses that the platform did business with, Vladimir Tenev, the co-founder and chief executive officer (CEO) of Robinhood, authorized an emergency borrowing of US$500 million[[3]](#endnote-3) from the company’s banks as well as the raising of $3.4 billion in equity from the venture funds that had financed the start-up.[[4]](#endnote-4) After Robinhood briefly disallowed trading on GameStop between January 27 and 29, Tenev and his team not only faced bipartisan political criticism—both Representative Alexandria Ocasio-Cortez, a Democrat from New York, and Senator Ted Cruz, a Republican from Texas, had demanded an investigation into the company’s actions[[5]](#endnote-5)—but also a class-action lawsuit filed by a group of investors who were unable to buy and sell GameStop stock on the platform and claimed that they had suffered financial losses as a result.[[6]](#endnote-6)

The emergency cash calls and the need for additional equity came at the end of a turbulent month for Robinhood. On December 16, 2020, the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth had filed an administrative complaint against the company, accusing it of (among other things) luring unwitting investors by “gamifying” the process of trading.[[7]](#endnote-7) The following day, the US Securities and Exchange Commission (SEC), which regulated public capital markets in the United States, imposed a $65 million fine on the company for not disclosing to its customers that it obtained the majority of its revenues via commissions for routing trade orders to market makers.[[8]](#endnote-8) The fine levied by the SEC followed a $1.25 million fine imposed by the Financial Industry Regulatory Authority (FINRA) on December 19, 2019, for a similar breach of fiduciary duty toward customers.[[9]](#endnote-9)

The seemingly unending stream of negative news and legal action surrounding the company came at a time when Robinhood had very quickly jumped past industry stalwarts such as E-Trade Financial Corporation (E-Trade) and TD Ameritrade, and, with its 15 million customers, posed a singular challenge to industry leader Charles Schwab Corporation (Schwab). The CEO of the start-up that was founded to “democratize finance for all”[[10]](#endnote-10) was hoping to take his company public via an initial public offering (IPO) in late 2021;[[11]](#endnote-11) but, before that, Tenev first needed to address the several challenges that Robinhood faced, including intense competition from the well-funded China-based start-up Webull Financial LLC (Webull).[[12]](#endnote-12) A response from CEO Tenev and his top management team was expected.

The Securities Brokerage Industry

According to IBISWorld, securities brokers acted as agents by arranging transactions between buyers and sellers of various types of financial securities such as stocks, bonds, options, and cryptocurrencies. The $150.8 billion industry was fragmented, with the top four firms—Bank of America, Wells Fargo & Company, Schwab, and Morgan Stanley—accounting for 29.3 per cent of the market share. While the industry had shown a negative growth rate in the 2015–2020 period, IBISWorld forecasted a growth rate of 1.5 per cent for the five years following this period.[[13]](#endnote-13)

The industry was broadly divided into full-service and discount brokerages. Full-service firms were typically owned by large banks and catered to high-net-worth individuals by offering concierge-style advice and order execution in return for high commissions. Such firms charged an account management fee that was a percentage of the account balance in addition to commissions on trading. In contrast, discount brokerages (up until 2019) charged a small commission (usually $9.99 per trade) in return for a do-it-yourself approach by its investors.[[14]](#endnote-14)

The advent of online brokerages was a disruptive event for the industry. Pioneered by E-Trade and followed later by others, online brokerages had, by 2010, amassed a collective market share of 19 per cent.[[15]](#endnote-15) This percentage increased as a result of both the entrance of mobile platforms that simplified the trading process and the global pandemic caused by COVID-19 in early 2020, which resulted in more people working from home amid periods of lockdowns in various parts of the United States, which accelerated growth.[[16]](#endnote-16) When Robinhood’s zero-commission trades became popular, other discount brokerages (such as Schwab and Fidelity Investments Inc.) followed suit (see Exhibit 1).

Retail investors accounted for 53.9 per cent of industry revenues in 2020, with non-institutional professional investors accounting for the remaining 46.1 per cent.[[17]](#endnote-17) IBISWorld further divided retail investors into those with less than $250,000 in investible funds, who typically were catered to by online discount brokerages, and those with $250,000 or more in investments, for whom full-service brokerages were the preferred option.[[18]](#endnote-18)

Historically, individual US investors were not invested in the stock market. According to a 2020 *Forbes* report, only 55 per cent owned stocks. Of these, only 14 per cent were directly invested in the stock market, with the rest owning stocks (in the form of mutual funds) as part of their retirement accounts.[[19]](#endnote-19) Online brokerages increased their stock market exposure in a major way, culminating in 10 million new accounts opened in 2020 alone. Online account holders tended to be active in trading and were said to be responsible for nearly 25 per cent of US trading activity.[[20]](#endnote-20)

Brokerages, which were essentially trading platforms that facilitated the buying and selling of securities, routed orders to a variety of players to execute transactions. Players such as market makers and regional exchanges paid a commission (i.e., payment for order flow, or PFOF) based on the order volume routed, and made money on the arbitrage between the buying and selling prices of securities. Clearing houses, which provided record-keeping and facilitated the exchange of securities, required deposits from brokerages based on the volume of orders transacted (see Exhibit 2).[[21]](#endnote-21) Even after moving to zero-fee trades, brokerages had multiple sources of revenues, including commissions from market makers and regional exchanges, interest on margin trading, and fees for options trading.[[22]](#endnote-22)

According to IBISWorld, a key success factor in the industry was the ability to serve as a one-stop shop for investors by providing them with a variety of investment products.[[23]](#endnote-23) As a result, players sought to increase their customers’ average account balance. While Schwab led with an average account balance of $255,000, TD Ameritrade (prior to its acquisition by Schwab) was second in average account balance, with $110,000, and E-Trade followed with $80,000. Robinhood customers’ average account balance was less than $5,000.[[24]](#endnote-24)

IBISWorld categorized the level of regulation in the securities brokerage industry as heavy and steady.[[25]](#endnote-25) The primary regulating body was the SEC. The FINRA was a self-regulatory body authorized by Congress to “protect America’s investors by making sure the broker-dealer industry operates fairly honestly.”[[26]](#endnote-26) In addition, various state regulatory bodies also regulated securities brokers.

Robinhood’s Origin Story

Baiju Bhatt and Tenev met in 2005 as roommates and graduate students in mathematics at Stanford University.[[27]](#endnote-27) Upon graduation, and after Tenev enrolled in and dropped out of the mathematics Ph.D. program at the University of California,[[28]](#endnote-28) the two moved to New York City and started a company that facilitated high-speed algorithmic stock trading.[[29]](#endnote-29) In 2011, they witnessed first-hand the Occupy Wall Street movement in the city, which galvanized the world in protesting against the significant economic divide between the putative 1 per cent[[30]](#endnote-30) (the small percentage of extremely wealthy people) and the remaining 99 per cent.[[31]](#endnote-31) Bhatt and Tenev had the idea that instead of making the wealthy even wealthier through their stock-trading algorithm, perhaps they could bring stock investing to the masses. They closed their New York City company and moved to the San Francisco Bay Area to work on their new idea.[[32]](#endnote-32) Bhatt spoke about the genesis of their idea:

Having worked in finance for a few years, we had the realization that capital markets were ones that were not letting a lot of people be a part of them, and the $10 trade commission was a major [reason]. . . . We had this crazy idea: If we make it free and make it really easy to use on mobile [devices], we could see a new generation of customers.[[33]](#endnote-33)

For Tenev, the impetus was more personal:

I was born behind the Iron Curtain. For people in my native Bulgaria managing money was a simple proposition with just two options—keeping savings in the state bank or stashing it under a mattress. Investing, of course, was off the table, as was accessing a line of credit. . . . In the US, my family found a country that celebrated choice as a cornerstone of the capitalist system. Competition and access enabled the US stock market to become the greatest engine of wealth creation in the history of the world. But while the market is theoretically open to everyone, some people have had better access, better tools, and a clearer invitation to participate. Others have been held back. . . . We conceived Robinhood in the wake of the Occupy Wall Street movement to level that playing field.[[34]](#endnote-34)

In order for the fledgling company, now named Robinhood Markets Inc., to act on its idea, it needed to acquire a broker-dealer licence. To get the licence, the duo needed to show that they had a year’s worth of operating capital in hand. Their initial attempts at fundraising were unsuccessful until they met Tim Draper, a venture capitalist. Draper agreed to fund the start-up but insisted that the duo not take a salary until the firm received its licence.[[35]](#endnote-35) This lack of a salary led to a challenging existence for the co-founders, as indicated by Bhatt: “We were basically out of money at that point. . . . There was a period of time when we’d bike to work every day, wear shoes with holes. Walked barefoot a lot back then. It was a tough time.”[[36]](#endnote-36)

With funding from additional sources and upon obtaining the requisite licence in October 2013, Robinhood (with its broker name as Robinhood Financial LLC)[[37]](#endnote-37) began operating as a broker-dealer in all 50 states in the United States and in Washington, DC; Puerto Rico; and the US Virgin Islands on January 21, 2014.[[38]](#endnote-38)

Business Model

Robinhood’s mission was “to democratize finance for all.” Toward this mission, its mobile trading platform application (app) used a minimalist design approach. When users accessed a company page on Robinhood, they saw just four components: the company’s ticker symbol, the stock price, a historical price chart, and a “Buy” button, located at the bottom of the screen, to make the trade. Users could scroll down to get more information about the stock. The app did not charge any fees or commissions.[[39]](#endnote-39) While Robinhood did not make any stock recommendations, the app contained both a first list (a list of stocks chosen based on their popularity on the platform), which new users saw, and “Popular Lists,” such as “100 Most Popular” and “Top Movers.”[[40]](#endnote-40) The app featured bursts of confetti that accompanied the consummation of transactions.[[41]](#endnote-41)

A *Fortune* reporter described the process of setting up a Robinhood account and investing via the app:

Signing up for Robinhood can feel like navigating a lazy mobile video game. Exuberant screens promise, “There’s free stock waiting.” Others offer a “Robin’s reward” digital scratch-and-win ticket—which in my case deposited $3.24 worth of an obscure health care stock into my account. Within 10 minutes, I was able to trade stocks and stock options. It’s all a quantum leap from the last time I opened a brokerage account, five years ago. That process took days, involved fax machines, and needless to say, offered no scratch-and-win prizes.[[42]](#endnote-42)

After initially starting out by offering only stock trading, Robinhood expanded to include margin trading (where traders borrowed money from the broker to make trades in return for interest), options trading, trading in fractional shares, and trading in cryptocurrencies. Both its 2018 and 2019 forays into banking—wherein Robinhood endeavoured to become a financial supermarket such as Schwab—failed, as it was unable to obtain regulatory approval.[[43]](#endnote-43)

Robinhood’s primary revenue source—which accounted for more than 70 per cent of its revenues—was the commission it generated (i.e., the PFOF) from routing its trades through market makers and regional exchanges.[[44]](#endnote-44) The PFOF accounted for $453 million in the first nine months of fiscal year 2020.[[45]](#endnote-45) Robinhood also obtained revenues from Robinhood Gold, a $5-a-month service that provided investors with research reports from Morningstar and enabled margin investing and interest on unused cash in customer accounts (see Exhibit 3).[[46]](#endnote-46)

The median age of a Robinhood customer was 31 years, with 70 per cent of users either millennials or belonging to Generation Z. Robinhood had a more ethnically diverse customer base as compared with its peers: 60 per cent of its customers were White (versus 78 per cent for peers); 19 per cent, Hispanic; 10 per cent, Asian; and 9 per cent, Black. Women formed one-third of its customer base.[[47]](#endnote-47) Both in the 2020 calendar year and in the aftermath of the volatile trading in GameStop stock in January 2021, Robinhood gained customers at a pace faster than its competition, gaining five million customers in the first 10 months of 2020 and more than 500,000 in January 2021 alone.[[48]](#endnote-48) In June 2020, Robinhood customers made 4,310 average daily trades compared with 1,800 for Schwab, 3,839 for TD Ameritrade (before its acquisition by Schwab), and 1,114 for E-Trade.[[49]](#endnote-49)

In early 2021, Robinhood had 1,886 employees and a market valuation of nearly $12 billion.[[50]](#endnote-50) It had secured $2.2 billion in funding before January 2021, and, after the GameStop frenzy, received $3.4 million in additional funding.[[51]](#endnote-51) In November 2020, co-founder Bhatt stepped down from his role as co-CEO to focus on product development, leaving Tenev as the company’s CEO.[[52]](#endnote-52)

Headwinds

Robinhood’s ease in increasing its customer base and obtaining media coverage for making stock trading more egalitarian was bookended by a series of challenges that went to the heart of its business model.

As trading activity increased on the Robinhood platform, the site experienced a series of crashes. Over an 11-month period in 2020, the site crashed for the whole or part of a day 70 times. One of these crashes occurred on March 2, 2020, a day that recorded the largest point gain in the Dow Jones Industrial Average up until that point. During this steep run-up in the market, Robinhood customers were unable to use the app to trade on March 2 and part of March 3. Investors who were locked out from trading on the platform filed a class-action lawsuit demanding financial remedies. During the January 2021 GameStop trading frenzy, Robinhood’s halting of trading on the stock led to protests and lawsuits from traders as well as pushback from politicians.[[53]](#endnote-53) Senator Elizabeth Warren, a Democrat from Massachusetts, wrote a letter to the company demanding an explanation as to why the platform disabled its customers from trading GameStop stock when hedge funds and institutional investors were allowed to do so: “Robinhood has a responsibility to treat its investors honestly and fairly, and provide them with access to the market under a transparent and consistent set of rules. . . . It is deeply troubling that the company may not be doing so.”[[54]](#endnote-54)

On June 12, 2020, Alexander Kearns, a 20-year-old student in Illinois, was found dead by suicide. An investigation into his death revealed that a major factor was Kearns’s negative $730,000 balance in his Robinhood account. Kearns had been trading complex options on his margin account (not realizing that an options trade would show a negative balance until both parts of the trade were executed) and his overwhelming anxiety over the accumulation of losses led him to throw himself in front of a moving train. In a note posted on Twitter, Kearns’s brother-in-law, Bill Brewster, referred to a message from Kearns: “How was a 20-year-old with no income able to get assigned almost a million dollars’ worth of leverage? . . . The puts I bought/sold should have cancelled out, too, but I also have no clue what I was doing now in hindsight.”[[55]](#endnote-55)

In response, Robinhood posted a letter on its blog:

On Saturday, we learned that Alex Kearns, a Robinhood customer, died by suicide and left a note citing confusion with our product. We quickly reached out to Alex’s family to share our condolences and offer to speak. We are personally devastated by this tragedy. Over the past week, our team at Robinhood has been focused on identifying how we can improve Robinhood’s customer experience, specifically around our option flows involving multi-leg exercise and assignment. We want to share with you today what we are committing to as a company moving forward.[[56]](#endnote-56)

The blog went on to identify specific steps that Robinhood planned to take, including changing the eligibility criteria for options trading as well as additional customer education.[[57]](#endnote-57)

In the aftermath of the Kearns’s suicide, influential New York University marketing professor Scott Galloway criticized the addictive nature of apps such as Robinhood:

Learning to invest and understanding the markets are good things, as is connecting with friends online. . . . to a point. Social media and gambling have the same addictive psychological mechanism: variable rewards (when you keep performing an action in hopes of getting a possible but unlikely reward). This is the type of behaviour that’s the “most addictive and [hardest to stop](https://www.cnbc.com/2018/05/10/google-employee-tristan-harris-internal-2013-presentation-warnings.html).” Robinhood management and investors have taken cues from Big Tech and made a conscious decision to disregard the well-being of our youth for personal enrichment.[[58]](#endnote-58)

In his annual predictions for 2021, Professor Galloway identified Robinhood as 2021’s “new menace” for its propensity to be more interested in the customer data it could sell to hedge funds than it was in its customers themselves.[[59]](#endnote-59)

On December 16, 2020, the Massachusetts Securities Division of the Office of the Secretary of the Commonwealth filed an administrative complaint against Robinhood that centred on Robinhood gamifying the investment process for unwary customers and luring them to trade in options without regard for their lack of financial expertise (see Exhibit 4). Concurrent with the filing, William Galvin, secretary of Massachusetts, made a tour of the media, including an interview on CNBC, and provided the following statement:

Robinhood, which earns revenue for trades executed by its customers, gave customers with no investment experience the ability to make a potentially unlimited number of trades, without properly screening them to be approved for options trading. . . . Treating this like a game and luring young and inexperienced customers to make more and more trades is not only unethical, but also falls far short of the standards we require in Massachusetts.[[60]](#endnote-60)

The complaint called for (1) a cease-and-desist order against the continuation of Robinhood’s current marketing practices, (2) the use of an independent consultant to review company policies, and (3) a monetary fine.[[61]](#endnote-61)

On the following day, December 17, 2020, the SEC announced that it had imposed a $65 million fine for Robinhood having failed to disclose to its customers that the company received PFOF from market makers and regional exchanges for routing trading orders (see Exhibit 4). As part of the complaint that resulted in the fine, the SEC said that Robinhood had violated its fiduciary duty of “best execution” in opting for PFOF rather than seeking the best prices for its customers.[[62]](#endnote-62) The SEC fine was an echo of a $1.25 million fine that FINRA had imposed on Robinhood in December 2019. In that instance, FINRA, the self-regulatory body of which Robinhood was a dues-paying member, penalized the company for “best execution violations.”[[63]](#endnote-63)

To add to Robinhood’s plethora of headwinds, the competitive intensity in the securities brokerage industry was increasing. In 2020, there were two major consolidations in the industry: In February, Morgan Stanley announced the acquisition of E-Trade,[[64]](#endnote-64) and in October, TD Ameritrade was acquired by Schwab.[[65]](#endnote-65) Webull was taking advantage of Robinhood’s problems by aggressively signing up new customers. In the aftermath of the GameStop-related shutting down of the Robinhood platform, the Webull app had 88 per cent more downloads in January 2021 as compared with December 2020, and 400 per cent more in January 2021 as compared with January 2020.[[66]](#endnote-66)

Looking Ahead

Based on the growth in customers signing up and trading on the platform, Robinhood’s quest to “democratize finance for all” appeared to be on the right trajectory in early 2021. While competitors, both from the traditional discount brokerage industry as well as from “me-too” start-ups such as China’s Webull, were hot on Robinhood’s heels, Robinhood had 15 million users and had forced both Schwab and Morgan Stanley to make acquisitions to surmount its threat. From its ability to raise $3.4 billion in an instant from venture funds following the deposit call from a clearing house, it was clear that Tenev and his team at Robinhood had the support and faith of the company’s investors.

However, the myriad challenges that confronted Robinhood, starting in 2020 and extending into 2021, meant that the company needed to look deeply into its business model and identify and incorporate changes to it as a prelude to going public in late 2021. In the aftermath of the GameStop frenzy, Elon Musk, the CEO of Tesla Inc.,[[67]](#endnote-67) nicknamed Tenev “Vlad the stock impaler,” referencing the start-up’s predilection for receiving PFOF over serving the interests of its customers.[[68]](#endnote-68)

As a platform business, Robinhood had experienced both the benefits and the dangers of network effects and had faced several market and non-market challenges. For Robinhood to go public via an IPO in mid-2021, it needed to select an exchange and file its registration papers in March 2021. These criteria meant that Tenev and the Robinhood team needed to respond to these challenges within the next month to pave the way for a successful public offering that would justify the lofty market valuation placed on the company by the venture capital market.

Exhibit 1: Profile of Selected Brokerages

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Brokerage | Profile | Stock Trading | Margin Trading | Options Trading | No. of Users |
| Charles Schwab Corporation | * In late 2020, completed its acquisition of TD Ameritrade and consequently had over $5.5 trillion in client assets. * Vertically integrated:   – Morningstar estimated that approximately 25% of client assets were in a Schwab proprietary product.   * Broad array of products: stocks, ETFs, individual accounts, and IRAs. * Allowed users to buy fractional shares. | $0 for both stocks and ETFs | 8.325% for trades up to $24,999 | $0.65 per unit | 29.2 million |
| Webull Financial LLC | * Theme: “Enjoy Tech. Enjoy Investing.” * Trading in stocks, options, ETFs, and cryptocurrencies; IRAs allowed. * China-based; founded by Alibaba Group alumni; offered free stock as incentive. * Did not offer fractional share ownership. | $0 for both stocks and ETFs | 6.99% for trades up to $25,000 | $0 | 2 million |
| Robinhood Markets Inc. | * Theme: “To democratize finance for all.” * Trading in stocks, options, and cryptocurrencies; no IRAs; offered free stock as incentive; allowed users to buy fractional shares. | $0 | No charge for margin trading, but investor had to subscribe for Robinhood Gold to do margin trading. A $5 per month Gold subscription gave the investor no-cost margin trading up to $1,000, with an interest rate of 5% after that. | $0 | 15 million |

Note: All currency amounts are in US dollars; EFTs = exchange traded funds; IRAs = individual retirement accounts.

Source: Charles Schwab, *Morningstar Equity Analysis*, accessed December 17, 2020, https://client.schwab.com/Areas/MvcGlobal/Global/ModPdfHandler?domainCode=0&path=%2Fresearch%2Fclient%2FStocks%2FReports%2FReportRetrieve&name=MorningstarEquityAnalystReport.pdf&pdfParams=Dockey=2039-0P00000175\_20210428\_RT-1&tokenRequired=y; Chris Markoch, “Actually, Schwab Just May Be ‘Killing It’ with Millennials,” MarketBeat, October 18, 2019, accessed December 17, 2020, www.marketbeat.com/originals/schwab-just-may-be-killing-it-with-millennials/; Charles Schwab, “Cost of Trading Equities, Options & EFTs,” accessed December 17, 2020, www.schwab.com/trading/pricing; Charles Schwab, “Schwab Acquisition of TD Ameritrade,” accessed December 17, 2020, www.aboutschwab.com/TDA; Webull, “Webull Financial Fee Schedule,” accessed December 17, 2020, www.webull.com/pricing; Webull (website), accessed December 17, 2020, www.webull.com/; Chris Butsch, “Robinhood vs. Webull—Battle of the Brokers,” Money under 30, July 6, 2020, accessed December 17, 2020, www.moneyunder30.com/robinhood-vs-webull; “Robinhood Is Losing Thousands of Traders to a China-Owned Rival,” Bloomberg, December 8, 2020, accessed December 17, 2020, www.bloomberg.com/news/articles/2020-12-08/robinhood-is-losing-thousands-of-day-traders-to-china-owned-webull; Robinhood Financial LLC, *Robinhood Financial Fee Schedule*, accessed December 17, 2020, https://cdn.robinhood.com/assets/robinhood/legal/RHF%20Fee%20Schedule.pdf; Jeff John Roberts, “Robinhood’s Next Adventure: Stealing Market Share from the Rich,” *Fortune*, December 3, 2020, accessed April 16, 2021, https://fortune.com/longform/robinhood-stock-trading-app-schwab-td-ameritrade-e-trade-market-share-stocks/.

Exhibit 2: Schematic of Stock Trade Execution

**Investors**

**Securities Brokers (Platforms)**

**Clearing Houses**

Exchanges—National and

Regional

Market Makers

Electronic

Communication

Networks

Own Inventory

(e.g., NYSE, Nasdaq,

NYSE Chicago)

(e.g., Citadel Securities,

Virtu Financial)

(e.g., Instinet, SelectNet)

*Step 1: Investor places order to buy or sell stock*

(e.g., Schwab, Robinhood, Morgan Stanley)

*Step 2: Broker chooses one of four channels below to execute trade. Per SEC rules, broker has a duty of “best execution”—choosing the channel based on execution speed and price.*

*Step 3: The clearing house executes order by transferring cash; also maintains record of transaction*

*Cash deposit as escrow*

*Market makers make payment to brokers for order flow*

*Some regional exchanges pay brokers for order flow*

(e.g., Depository Trust & Clearing Corporation)

Note: SEC = Securities and Exchange Commission; Schwab = Charles Schwab Corporation; Robinhood = Robinhood Markets Inc.; NYSE = New York Stock Exchange; SelectNet = SelectNet Internet Services.

Source: Created by the author based on US Securities and Exchanges Commission, “Executing an Order,” accessed January 31, 2021, www.investor.gov/introduction-investing/investing-basics/how-stock-markets-work/executing-order; Nathaniel Popper et al., “The Silicon Valley Start-Up That Caused Wall Street Chaos,” *New York Times*, January 30, 2021, accessed January 31, 2021, www.nytimes.com/2021/01/30/business/robinhood-wall-street-gamestop.html.

Exhibit 3: Revenue Sources for Selected Competitors

(average % of total revenues for 2019, 2018, and 2017)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Revenue Source | TD Ameritrade\* | Charles Schwab Corporation | E-Trade Financial Corporation† | Robinhood Financial Markets Inc. |
| Payment for Order Flow | 8.43 | 3.39 | 6.09 | 70.00 |
| Interest | 22.53 | 61.00 | 63.73 | … |
| Other (Commissions, Asset Management Fee, etc.) | 69.04 | 35.61 | 30.18 | … |

\* On October 6, 2020, Charles Schwab completed its acquisition of TD Ameritrade Holding Corporation.

† On October 2, 2020, Morgan Stanley completed its acquisition of E-Trade Financial Corporation.

Source: Zacks Equity Research, “Schwab Closes TD Ameritrade Buyout, Creates a Broker Behemoth,” Nasdaq, October 7, 2020, accessed December 20, 2020, [www.nasdaq.com/articles/schwab-closes-td-ameritrade-buyout-creates-a-broker-behemoth-2020-10-07](https://www.nasdaq.com/articles/schwab-closes-td-ameritrade-buyout-creates-a-broker-behemoth-2020-10-07); E\*TRADE Financial Holdings LLC, “Morgan Stanley Closes Acquisition of E\*TRADE,” press release, October 2, 2020, accessed December 20, 2020, https://about.etrade.com/newsroom/press-releases/article?gmodStoryID=8632668458819 364; TD Ameritrade Holding Corporation, *Form 10-K 2019*, accessed December 29, 2020, <https://d18rn0p25nwr6d.cloudfront.net/CIK-0001173431/00bb443e-3e7b-4338-b5e9-2fd8c0a1425f.pdf>; The Charles Schwab Corporation, *Form 10-K 2019*, accessed December 29, 2020, <https://content.schwab.com/web/retail/public/about-schwab/SEC_Form10k_2019.pdf>, E\*TRADE Financial Corporation, *Form 10-K 2019*, accessed December 29, 2020, https://app.quotemedia.com/data/downloadFiling?webmasterId=103216&ref=114809404&type=PDF&symbol=ETFC&companyName=E\*TRADE+Financial+Corporation&formType=10-K&formDescription=Annual+report+pursuant+to+Section+13+or+15% 28d%29&dateFiled=2020-02-19&CK=1015780; Jeff John Roberts, “Robinhood’s Next Adventure: Stealing Market Share from the Rich,” *Fortune*, December 3, 2020, accessed April 16, 2021, https://fortune.com/longform/robinhood-stock-trading-app-schwab-td-ameritrade-e-trade-market-share-stocks/.

Exhibit 4: Summary of Charges by the Massachusetts Securities Division and the US Securities and Exchanges Commission

Massachusetts Securities Division, December 16, 2020, Administrative Complaint

|  |  |
| --- | --- |
| **Charge** | **Charge Details** |
| **Marketing: Aggressive Marketing of Stocks and Options without Regard for Customers’ Best Interest** | * Used aggressive tactics to lure new and often inexperienced investors to trading platform. * Used gamification strategies (e.g., confetti on screen after completing a trade, use of emojis in recurring push notifications) to increase usage of app. * Securities lists (e.g., 100 Most Popular, Top Movers) that have the potential to influence customers; securities on the lists are not vetted for suitability. * Promise of free stock (e.g., Microsoft Corporation, Visa Inc., Apple Inc.) despite low probability of customer getting a well-known company as stock. * Suggesting the possibility of receiving up to US$500 by recommending others to the app. * Profile of 25 traders with no investment experience indicated that the average trades per day was between 15 and 92. * Company’s stated policy for options trading was at least four completed trades and some self-reported investment experience. Company violated this by enabling at least 340 investors with no experience and no completed prior trades to trade options; approximately 68% approved for trading had no prior experience. |
| **Infrastructure: Inadequate** | * Platform suffered 70 outages and disruptions between January 1, 2020, and November 30, 2020. |
| **Infrastructure to Meet Growing User Base Resulted in Disservice to Customers** | * At least seven of these outages prevented customers from transacting using the platform. * For all of May 2, 2020 (the largest single-day rise in the Dow Jones Industrial Average of 1,290 points), an outage prevented customers from using the platform. * During outages, the help centre completely shut down to disable both email and phone contact with company. |

Securities and Exchange Commission’s December 17, 2020, Cease-and-Desist Order

|  |  |
| --- | --- |
| Charge | Charge Details |
| Disclosure: Misrepresentations and Inadequate Disclosure regarding PFOF as Revenue Source | * Robinhood routes trades through market makers who pay a commission to the platform for orders received. * In making the trade-off between higher commissions and better prices for stocks, Robinhood opted for higher commissions. * Between October 2016 and June 2019, Robinhood customers lost US$34.1 million due to inferior prices, even after deducting commission for trades. * History of inadequate or incorrect disclosure with regard to PFOF as a revenue source. Either the FAQs section of Robinhood’s website ignored this source or stated that this was a small source of revenue (even when it was nearly 80% of revenues in 2015). * Phone representatives were told to not answer the PFOF question and to instead refer callers to the FAQs section. |

Note: PFOF = payment for order flow; FAQs = frequently asked questions.

Source: Commonwealth of Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *Administrative Complaint against Robinhood Financial LLC*, December 16, 2020, accessed December 18, 2020, www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf; Securities and Exchange Commission, *Order Instituting Administrative and Cease-and-Desist Proceedings in the Matter of Robinhood Financial LLC*, December 17, 2020, accessed December 18, 2020, www.sec.gov/litigation/admin/2020/33-10906.pdf.

ENDNOTES

1. This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Robinhood Markets Inc., or any of its employees. [↑](#endnote-ref-1)
2. Peter Rudegeair and Orla McCaffrey, “Wild Stock Ride Tests Robinhood,” *Wall Street Journal*, Saturday/Sunday, January 30–31, 2021, A1, A10. [↑](#endnote-ref-2)
3. All currency amounts are in US dollars. [↑](#endnote-ref-3)
4. Rudegeair and McCaffrey, op. cit.; Kate Kelly et al., “Robinhood, in Need of Cash, Raises $1 Billion from Its Investors,” *New York Times*, January 29, 2021, accessed January 30, 2021, www.nytimes.com/2021/01/29/technology/robinhood-fundraising.html. [↑](#endnote-ref-4)
5. Kevin Shalvey, “AOC, Ted Cruz, and Fellow Lawmakers Are Demanding Answers after Swings in GameStop Stock. Here’s What They Said,” Business Insider, accessed January 30, 2021, www.msn.com/en-us/money/markets/aoc-ted-cruz-and-fellow-lawmakers-are-demanding-answers-after-swings-in-gamestop-stock-here-s-what-they-said/ar-BB1detZ2. [↑](#endnote-ref-5)
6. Alicia Adamczyk, “Investors Are Using This App to Automatically Join the Robinhood Class-Action Lawsuit amid GameStop Chaos,” CNBC, January 29, 2021, accessed January 30, 2021, www.cnbc.com/2021/01/29/app-robinhood-gamestop-class-action-lawsuit.html. [↑](#endnote-ref-6)
7. Maggie Fitzgerald, “Massachusetts Secretary of Commonwealth Galvin Says Robinhood Is a Reckless Company Gamifying Investing,” CNBC, December 16, 2020, accessed January 30, 2021, www.cnbc.com/2020/12/16/massachusetts-sec-o-commonwealth-galvin-says-robinhood-is-a-reckless-company-gamifying-investing.html. [↑](#endnote-ref-7)
8. Chris Isidore and Matt Egan, “Robinhood Agrees to Pay a $65 Million Fine for Deceiving Clients,” CNN, December 17, 2020, accessed January 30, 2021, www.cnn.com/2020/12/17/investing/robinhood-sec-settlement-deceptive-practices/index.html. [↑](#endnote-ref-8)
9. Financial Industry Regulatory Authority, “FINRA Fines Robinhood Financial, LLC $1.25 Million for Best Execution Violations,” news release, December 19, 2019, accessed January 30, 2021, www.finra.org/media-center/newsreleases/2019/finra-fines-robinhood-financial-llc-125-million-best-execution. [↑](#endnote-ref-9)
10. Robinhood, “About Us | Robinhood,” accessed April 22, 2021, https://robinhood.com/us/en/about-us/. [↑](#endnote-ref-10)
11. Zacks Equity Research, “Will an IPO Help Robinhood Survive Zero-Commission Trade Battle?,” Nasdaq, December 15, 2020, accessed January 30, 2021, www.nasdaq.com/articles/will-an-ipo-help-robinhood-survive-zero-commission-trade-battle-2020-12-15. [↑](#endnote-ref-11)
12. “Robinhood Is Losing Thousands of Traders to a China-Owned Rival,” Bloomberg, December 8, 2020, accessed January 30, 2021, www.bloomberg.com/news/articles/2020-12-08/robinhood-is-losing-thousands-of-day-traders-to-china-owned-webull. [↑](#endnote-ref-12)
13. Nick Masters, *Securities Brokering in the US*, IBISWorld, July 2020, accessed January 30, 2021, https://my-ibisworld-com.stetson.idm.oclc.org/us/en/industry/52312/about. [↑](#endnote-ref-13)
14. Ibid. [↑](#endnote-ref-14)
15. John Aidan Byrne, “Online Brokerages Still Grabbing Market Share from Wirehouses,” WealthManagement.com, July 26, 2011, accessed January 30, 2021, www.wealthmanagement.com/selling/online-brokerages-still-grabbing-market-share-wirehouses. [↑](#endnote-ref-15)
16. Masters, op. cit. [↑](#endnote-ref-16)
17. Ibid. [↑](#endnote-ref-17)
18. Ibid. [↑](#endnote-ref-18)
19. Teresa Ghilarducci, “Most Americans Don’t Have a Real Stake in the Stock Market,” *Forbes*, August 31, 2020, accessed February 3, 2021, www.forbes.com/sites/teresaghilarducci/2020/08/31/most-americans-dont-have-a-real-stake-in-the-stock-market/?sh=75c1e3d01154. [↑](#endnote-ref-19)
20. Caitlyn McCabe, “New Army of Individual Investors Flexes Its Muscle,” *Wall Street Journal*, December 30, 2020, accessed April 16, 2021, www.wsj.com/articles/new-army-of-individual-investors-flexes-its-muscle-11609329600. [↑](#endnote-ref-20)
21. US Securities and Exchanges Commission, “Executing an Order,” accessed January 31, 2021, www.investor.gov/introduction-investing/investing-basics/how-stock-markets-work/executing-order. [↑](#endnote-ref-21)
22. “How Do Brokers Make Money with $0 Commission Free Trades?,” Brokerage-Review.com, accessed January 30, 2021, www.brokerage-review.com/investing-firm/make-money/with-zero-commissions.aspx. [↑](#endnote-ref-22)
23. Masters, op. cit. [↑](#endnote-ref-23)
24. Jeff John Roberts, “Robinhood’s Next Adventure: Stealing Market Share from the Rich,” *Fortune*, December 3, 2020, accessed April 16, 2021, https://fortune.com/longform/robinhood-stock-trading-app-schwab-td-ameritrade-e-trade-market-share-stocks/. [↑](#endnote-ref-24)
25. Ibid. [↑](#endnote-ref-25)
26. FINRA, “About FINRA,” accessed February 2, 2021, www.finra.org/about. [↑](#endnote-ref-26)
27. Ainsley Harris, “How Brokerage App Robinhood Got Millennials to Love the Market,” *Fast Company*, August 14, 2017, accessed December 17, 2020, www.fastcompany.com/40437888/how-brokerage-app-robinhood-got-millennials-to-love-the-market?cid=search. [↑](#endnote-ref-27)
28. *Forbes*, “2016 30 under 30: Finance,” January 4, 2016, accessed December 17, 2020, www.forbes.com/pictures/mdg45ejdik/vlad-tenev-28/?sh=10edc3827375. [↑](#endnote-ref-28)
29. Ibid. [↑](#endnote-ref-29)
30. Emily Stewart, “We Are (Still) the 99 Percent,” May 2, 2019, accessed April 22, 2021, www.occupy.com/article/we-are-still-99-percent#sthash.sHkZKquW.dpbs. [↑](#endnote-ref-30)
31. Sissi Cao, “Robinhood CEO Opens Up about How He Convinced Tim Draper to Back His Crazy Idea,” *Observer*, September 10, 2018, accessed December 17, 2020, https://observer.com/2018/09/robinhood-ceo-tells-how-he-convinced-tim-draper-back-idea/. [↑](#endnote-ref-31)
32. Jeff Kauflin, Antoine Gara, and Sergei Klebnikov, “The Inside Story of Robinhood’s Billionaire Founders, Option Kid Cowboys and the Wall Street Sharks That Feed on Them,” *Forbes*, October 20, 2020, accessed December 17, 2020, www.forbes.com/sites/jeffkauflin/2020/08/19/the-inside-story-of-robinhoods-billionaire-founders-option-kid-cowboys-and-the-wall-street-sharks-that-feed-on-them/?sh=4662b50c268d. [↑](#endnote-ref-32)
33. Cao, op. cit. [↑](#endnote-ref-33)
34. Vlad Tenev, “Robinhood CEO: Becoming an Investor Is the New American Dream, Just Like Home Ownership Was Before,” CNBC, January 27, 2021, accessed January 30, 2021, www.cnbc.com/2021/01/27/robinhood-ceo-becoming-an-investor-is-the-new-american-dream-just-like-home-ownership-was-before.html?&qsearchterm=vlad%20tenev. [↑](#endnote-ref-34)
35. Cao, op. cit. [↑](#endnote-ref-35)
36. Ibid. [↑](#endnote-ref-36)
37. While the parent company was called Robinhood Markets Inc., its brokerage arm did business as Robinhood Financial LLC. For the sake of clarity, the name Robinhood is used to denote the trading part of the parent company. [↑](#endnote-ref-37)
38. “Robinhood Financial, LLC,” BrokerCheck, accessed December 17, 2020, https://brokercheck.finra.org/firm/summary/165998. [↑](#endnote-ref-38)
39. Harris, op. cit. [↑](#endnote-ref-39)
40. Commonwealth of Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, *Administrative Complaint against Robinhood Financial LLC*, December 16, 2020, accessed December 18, 2020, www.sec.state.ma.us/sct/current/sctrobinhood/MSD-Robinhood-Financial-LLC-Complaint-E-2020-0047.pdf. [↑](#endnote-ref-40)
41. David Ingram, “Designed to Distract: Stock App Robinhood Nudges Users to Take Risks,” NBC News, September 12, 2019, accessed December 17, 2020, www.nbcnews.com/tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071. [↑](#endnote-ref-41)
42. Roberts, op. cit. [↑](#endnote-ref-42)
43. Annie Massa et al., “Eat. Sleep. Robinhood. Repeat,” *Bloomberg Businessweek*, no. 4675, October 26, 2020, 22–27. [↑](#endnote-ref-43)
44. Roberts, op. cit. [↑](#endnote-ref-44)
45. Ibid. [↑](#endnote-ref-45)
46. Robinhood, “How We Make Money,” accessed February 2, 2021, https://robinhood.com/us/en/about-us/how-we-make-money/. [↑](#endnote-ref-46)
47. Roberts, op. cit. [↑](#endnote-ref-47)
48. Rudegeair and McCaffrey, op. cit. [↑](#endnote-ref-48)
49. Roberts, op. cit. [↑](#endnote-ref-49)
50. Craft.co, “Robinhood,” accessed February 2, 2021, https://craft.co/robinhood; Rudegeair and McCaffrey, op. cit. [↑](#endnote-ref-50)
51. Crunchbase, “Robinhood,” accessed February 3, 2021, www.crunchbase.com/organization/robinhood/company\_financials; Alex Veiga, “Robinhood Raises $3.4B from Investors amid Surge in Trading,” AP, February 1, 2021, accessed February 3, 2021, https://apnews.com/article/robinhood-investors-gamestop-reddit-b49f4aed795b09478951fbbd1c566885. [↑](#endnote-ref-51)
52. Catherine Ross, “Robinhood Co-founder Steps Down from CEO Position,” Benzinga, November 21, 2020, accessed February 2, 2021, www.benzinga.com/news/20/11/18476687/robinhood-co-founder-steps-down-from-ceo-position. [↑](#endnote-ref-52)
53. Matthew Impelli, “Robinhood’s ‘Let the People Trade’ Tweet Resurfaces after Platform Halts GameStop Trading,” *Newsweek*, January 28, 2021, accessed February 3, 2021, www.newsweek.com/robinhoods-let-people-trade-tweet-resurfaces-after-platform-halts-gamestop-trading-1565156. [↑](#endnote-ref-53)
54. Dan Mangan and Thomas Franck, “Sen. Elizabeth Warren Asks Robinhood to Explain Why It Restricted GameStop Trades after Hedge Funds’ Losses,” CNBC, February 2, 2021, accessed February 3, 2021, www.cnbc.com/2021/02/02/elizabeth-warren-asks-robinhood-to-explain-gamestop-trade-restrictions.html. [↑](#endnote-ref-54)
55. Matt Egan, “Apparent Suicide by 20-Year-Old Robinhood Trader Who Saw a Negative $730,000 Balance Prompts App to Make Changes,” CNN Business, June 20, 2020, accessed February 2, 2021, www.cnn.com/2020/06/19/business/robinhood-suicide-alex-kearns/index.html. [↑](#endnote-ref-55)
56. Vlad Tenev and Baiju Bhatt, “Commitments to Improving Our Options Offering,” *Under the Hood: The Official Robinhood Blog,* June 19, 2020, accessed February 3, 2021, https://blog.robinhood.com/?offset=1585925945783&reversePaginate=true. [↑](#endnote-ref-56)
57. Ibid. [↑](#endnote-ref-57)
58. Scott Galloway, “Robinhood Has Gamified Online Trading into an Addiction,” Marker, June 23, 2020, accessed February 5, 2021, https://marker.medium.com/robinhood-has-gamified-online-trading-into-an-addiction-cc1d7d989b0c. [↑](#endnote-ref-58)
59. “Predictions 2021 with Scott Galloway | Section4,” YouTube video, 1:13:21, posted by “Section4,” December 29, 2020, accessed February 5, 2021, www.youtube.com/watch?t=2357&v=umUmrzounFI&feature=youtu.be&ab\_channel=Section4. [↑](#endnote-ref-59)
60. Pippa Stevens, “Massachusetts Regulators File Complaint against Robinhood, Alleging Manipulation of Customers,” CNBC, December 16, 2020, accessed February 2, 2021, www.cnbc.com/2020/12/16/robinhood-reportedly-facing-complaint-by-massachusetts-regulators-over-targeting-young-users.html. [↑](#endnote-ref-60)
61. Commonwealth of Massachusetts Securities Division of the Office of the Secretary of the Commonwealth, op. cit. [↑](#endnote-ref-61)
62. Securities and Exchange Commission, *Order Instituting Administrative and Cease-and-Desist Proceedings in the Matter of Robinhood Financial LLC*, December 17, 2020, accessed December 18, 2020, www.sec.gov/litigation/admin/2020/33-10906.pdf. [↑](#endnote-ref-62)
63. Financial Industry Regulatory Authority, op. cit. [↑](#endnote-ref-63)
64. Anuradha Garg, “Morgan Stanley Closes the E-trade Acquisition,” Market Realist, October 6, 2020, accessed February 3, 2021, https://marketrealist.com/p/morgan-stanley-buys-etrade/. [↑](#endnote-ref-64)
65. Dave Kovaleski, “Schwab Closes on TD Ameritrade Acquisition,” The Motley Fool, October 6, 2020, accessed February 3, 2021, www.fool.com/investing/2020/10/06/schwab-closes-on-td-ameritrade-acquisition/. [↑](#endnote-ref-65)
66. Christopher Zara, “Robinhood’s GameStop Restrictions Were a Rocket Boost for Webull,” *Fast Company*, January 29, 2021, accessed February 3, 2021, www.fastcompany.com/90599420/robinhoods-gamestop-restrictions-were-a-rocket-boost-for-webull. [↑](#endnote-ref-66)
67. Kate Duffy, “Elon Musk Tells His 44.8 Million Twitter Followers He’s Stepping Away from the Platform ‘For a While,’” Business Insider, February 2, 2021, accessed February 5, 2021, www.msn.com/en-us/news/technology/elon-musk-tells-his-448-million-twitter-followers-hes-stepping-away-from-the-platform-for-a-while/ar-BB1djwky?ocid=uxbndlbing. [↑](#endnote-ref-67)
68. “High-Frequency Traders Are in the Spotlight,” *Economist*, February 6, 2021, accessed February 5, 2021, www.economist.com/finance-and-economics/2021/02/06/high-frequency-traders-are-in-the-spotlight. [↑](#endnote-ref-68)