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THE WALL STREET JOURNAL.

GameStop Rally Fuels Scrutiny Of Payments to Online Brokers

By Alexander Osipovich
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The Reddit-fueled frenzy in stocks such as GameStop Corp. and AMC Entertainment Holdings Inc. is prompting calls for regulators to reconsider a decades-old practice in the U.S. stock market: payment for order flow.

The practice, in which high-speed trading firms pay brokerages for the right to execute orders submitted by individual investors, has long been controversial. Some have said it warps the incentives of brokers and encourages them to maximize their revenue at the expense of customers. Supporters, including many brokers and trading firms, said it helps ensure investors get seamless executions and good prices on trades.

Last year, brokerages such as Charles Schwab Corp., TD Ameritrade, Robinhood Markets Inc. and E*Trade collected nearly $2.6 billion in payments for stock and option orders, according to JMP Securities. The biggest sources of the payments were electronic-trading firms such as Citadel Securities, Susquehanna International Group LLP and Virtu Financial Inc.

Payment for order flow helped set the stage for the manic trading in GameStop, whose shares began the year around $18, surged to a record close of $347.51 on Jan. 27 and ended Thursday's session at $53.50. Other once-hot stocks such as AMC and Koss Corp. fell more than 20% on Thursday as the Reddit rally lost steam.

Trading firms make money by selling shares for slightly more than they are willing to buy them, and pocketing the difference. They are willing to pay for order flow from online brokerages because they are less likely to lose money trading against individual investors than on an exchange, where traders tend to be larger and more sophisticated.

Payment for order flow made it possible for the U.S. brokerage industry to shift to zero-commission trades in late 2019. No longer needing to pay a fee on stock transactions and empowered by apps like Robinhood, individual investors poured into stocks and options at record levels last year. More recently, they snapped up stocks like GameStop that were touted on Reddit.

The debate over payment for order flow boiled over last week after some brokerages restricted trading in GameStop, sparking speculation that the curbs were imposed at the behest of giant trading firms that handle those brokers' order flow. Firms like Citadel Securities denied being behind the curbs, which were prompted by brokers' need to post additional collateral. Still, criticism of payment for order flow grew.

"Payment for order flow, at the end of the day, is legalized bribery that appears to incentivize brokers to violate rules," said Dennis Kelleher, president of Better Markets, an advocacy group that lobbies for tighter financial regulations.

Public.com, a startup that offers an investing app that competes with Robinhood, said Monday it would no longer accept payment for order flow.

Some Silicon Valley investors, including Benchmark Capital partner Bill Gurley and the billionaire former Facebook Inc. executive Chamath Palihapitiya, attacked payment for order flow on Twitter. Mr. Gurley urged the Securities and Exchange Commission to end the practice, writing Sunday: "If the SEC/government wants to 'fix the plumbing' the number one thing they should do is ban Payment for Order Flow."

Payment for order flow is likely to come up at a House Financial Services Committee hearing on Feb. 18 devoted to GameStop, said Rep. Al Green (D., Texas), a member of the committee. "The question we have to ask ourselves is . . . Does this inherently create some conflict of interest?" he said.

One of the early practitioners of payment for order flow, and a dent to the practice's reputation, was Bernie Madoff. He helped pioneer the practice at his firm, Bernard L. Madoff Investment Securities, years before his conviction for running a multibillion-dollar Ponzi scheme.

The SEC reviewed payment for order flow several times since the 1990s and repeatedly condoned the practice.

Proponents of payment for order flow said it benefits investors because it allows individual investors to get better prices for their trades than if the orders were sent to stock exchanges. "If you ban payment for order flow, the individual investor is going to be worse off," said Robert Battalio, a finance professor at the University of Notre Dame.

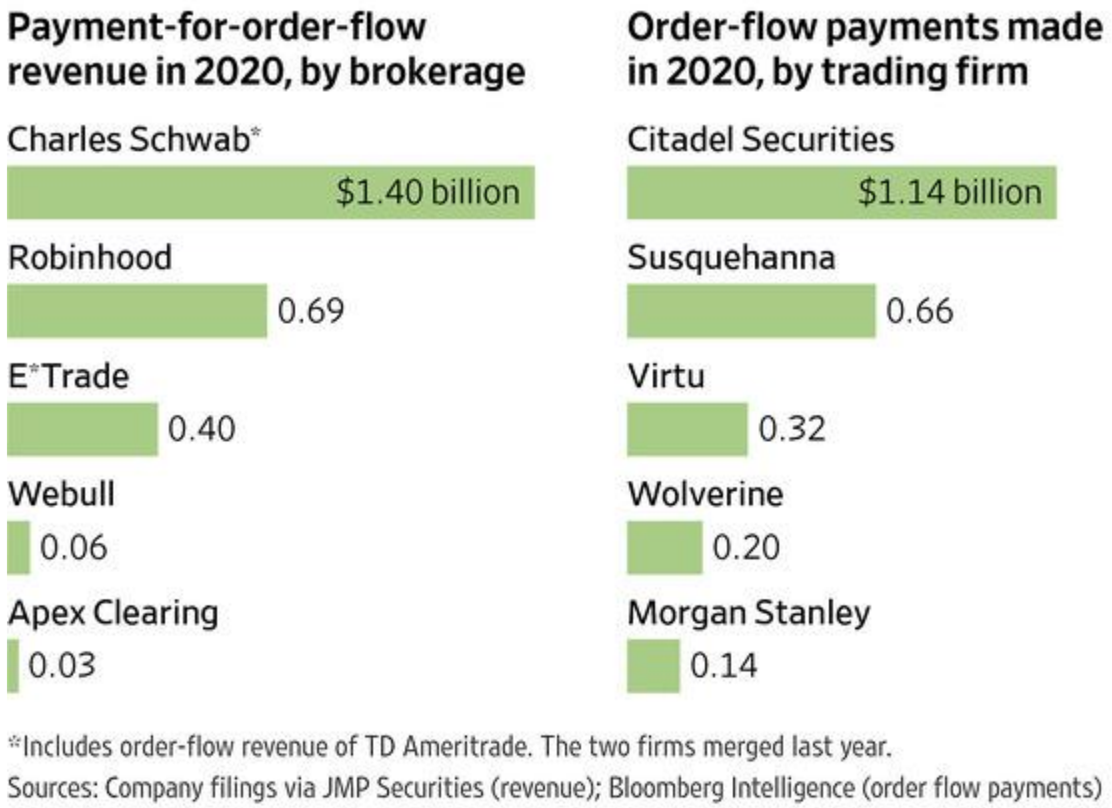
That is because of what brokers call price improvement -- when an investor's order is filled at a price slightly better than what is available on an exchange. For instance, suppose Apple Inc. shares can be sold for $135 at Nasdaq. An investor selling 100 shares of Apple could earn $13,500 if the order was executed on the exchange. But if the investor's sell order were routed to a trading firm such as Virtu, the firm could buy the shares for a fraction of a penny per share higher than $135, and the investor would get more money -- say, $13,505.

While such differences might seem small, they add up. Last year, investors saved about $3.7 billion on stock trades thanks to price improvement, according to Bloomberg Intelligence.

Trading firms said they compete to provide the most price improvement to brokers. "The magnitude of the orders routed to us reflects the confidence of the retail brokerage community in our systems engineering, reliability, balance sheet and execution quality," said Joe Mecane, Citadel Securities' head of execution services.

Potentially, the SEC could prohibit the payments and require investors' orders to be routed to exchanges, rather than being privately executed by electronic trading firms. But that would make it harder for brokerages to offer their customers zero-commission trades, and it is unclear that investors would get a better deal.

Some industry veterans expect little to change. "It's a practice that reflects economic realities, and it benefits retail investors in the form of low commissions," said Jamie Selway, a former executive with Investment **Technology** Group Inc.



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SEC Leader Thrust Into Market Mania

By Dave Michaels and Paul Kiernan
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WASHINGTON -- The trading mania around shares of companies like GameStop Corp. this week poses a dilemma for Gary Gensler, the Biden administration's choice to head the Securities and Exchange Commission: While broadening investor participation, the stampede also poses new risks that could spread to other participants.

The SEC generally encourages greater involvement of retail investors. But as more individuals become short-term speculators trading on momentum signals and not much else, the agency could come in for blame when bubbles burst and investors are saddled with losses. There are also implications for the brokerage business, which feeds off the higher demand and can be hobbled by the volatility it creates.

The SEC said Friday that it would examine whether any traders manipulated prices by exhorting others on social-media websites to buy the trendy stocks. The upheaval occurs at a time when Congress has questioned the regulator's supervision of the retail investing landscape.

"There are problems emerging that are going to have to be dealt with, and my guess is Gary Gensler will want recommendations on his desk when he walks in on the first day," said Mark Berman, a regulatory consultant and former SEC official.

Since stepping down from his role leading the Commodity Futures Trading Commission in early 2014, Mr. Gensler has been teaching finance at the Massachusetts Institute of **Technology** and writing about financial-**technology** innovation, including the rise of cryptocurrencies such as bitcoin.

A different trend appears to be at work this week: the combination of social media and financial **technology** that makes it easier and cheaper to trade. SEC officials who briefed House lawmakers this week said that social media isn't a new factor in trading but has become a more important driver in retail investing, according to a person familiar with the meeting.

A younger generation of traders has shunned traditional gatekeepers -- brokers who give advice over the phone or in person -- in favor of making their own decisions about which securities to buy.

Inexperienced investors looking for trading ideas can ride the momentum created by communities such as Reddit's WallStreetBets, where gung-ho traders goad one another to buy shares and hold them until the price goes "to the moon," as the traders often say. Their tolerance for losses is high, and many participants revel in buying stocks that are disfavored by bigger investors such as hedge funds.

Trading platforms such as Robinhood Markets Inc. have benefited. Robinhood doesn't charge commissions, and its "gamification" features celebrate trading with digital confetti and enable push notifications that keep the market on users' minds.

This week's surge in trading temporarily prompted Robinhood to prevent customers from buying some of the most popular stocks. The firm said it made the move for risk-management reasons. Robinhood and other online brokers were asked to provide more cash to clearinghouses to cover transactions.

The four-member SEC said Friday it would closely review the firms' explanations for their moves to limit trading.

SEC rules were updated in 2019 to require stockbrokers to act in the best interests of investors when providing investment advice. But Robinhood, Charles Schwab Corp. and other online trading platforms avoid such rules when they enable investors to buy and sell shares on their own, without the intermediation of a broker.

Democratic lawmakers have said the rules are too weak, mainly because they didn't ban many conflicts of interest that brokers face. Democrats are likely to have more influence over the SEC's agenda because they will control relevant committees in both the House and the Senate.

"These wild fluctuations are just the latest indication that many private-equity firms, hedge funds, and other investors, big and small, are treating the stock market like a casino, giving little consideration to the companies, communities, workers, and consumers that may be affected by these risky bets," Sen. Elizabeth Warren (D., Mass.) wrote Friday in a letter to the SEC.

Sen. Sherrod Brown (D., Ohio), who will take over as chairman of the Senate Banking Committee, which oversees the SEC, said this week he would convene a hearing to examine the tumult and the commission's supervision.

His counterpart in the House, Rep. Maxine Waters (D., Calif.), chairwoman of the Financial Services Committee, said Thursday she would hold a hearing.

But Sen. Pat Toomey (R., Pa.) said low-cost trading platforms have largely been a positive development for smaller investors and urged restraint.

"When examining this episode, regulators and Congress should tread with extreme caution and avoid needlessly inserting themselves into equity markets," Mr. Toomey said.

One of Mr. Gensler's recent MIT lectures looked at Robinhood, Charles Schwab and other firms that offer free trading, a trend he traced to the abolition of fixed commission rates in the 1970s, according to a video of the class available online. Mr. Gensler didn't criticize Robinhood in his lecture but explained how its growth influenced other brokers to copy its pricing model.

"What we've found whether it is in Facebook or many other online applications outside of the financial world, it is zero fee," Mr. Gensler said in the lecture. "And then the business model is earning money is some other way."

Mr. Gensler didn't respond to a voice-mail message seeking comment Friday.

With commissions at zero, online brokers have to make money other ways. One is to sell customers' orders to high-speed traders, which execute them like a stock exchange would. The speedy traders have profitable ways to trade with mom-and-pop orders and get deeper insight into market demand.

Siobhan Hughes and Orla McCaffrey contributed to this article.

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Year-End Review & Outlook: Markets & Finance (A Special Report) --- New Army of Individual Investors Arrives, Flexes Its Muscle

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The online brokerage industry might be hard pressed to outdo the record-breaking year it experienced in 2020, but for now, few are betting against it.

Individual investors opened more than 10 million new brokerage accounts in 2020, JMP Securities estimates, a record. Interest isn't fading, either: App downloads for brokerage firms, while lower than earlier in the year, remain resilient, with the Robinhood Markets Inc. app expected to reach 500,000 downloads in December alone, data provided by the investment bank shows. Website traffic for well-entrenched brokerages, including TD Ameritrade Holding Corp. and E*Trade Financial Corp., continues to increase as well.

"You have this incredibly engaged customer," said Devin Ryan, senior research analyst at JMP Securities. "It appears that the end-customer is actually logging into their account more than they were at the beginning of the pandemic."

The year will be known as the time when individual investors dove into financial markets and doubled down, even in the midst of a global pandemic, strapping in for a roller-coaster ride that sent stocks plummeting -- and then skyrocketing -- in record time.

Driving the interest was a combination of factors that started with an industrywide shift to commission-free trading in 2019 but swelled as market volatility grew. As the coronavirus rolled across the U.S., millions of new investors found themselves stuck at home, some with extra time on their hands to learn about the markets. Others, unable to bet on sports or visit casinos, found the stock market's outsize swings presented the perfect outlet to make bets.

In some cases, those wagers became a part of investing sensations, owing to the countless online forums where traders gathered to swap ideas. Similar to the online chat rooms that surrounded the late-1990s dot-com bubble, social-media sites such as Facebook, TikTok and the messaging platform Discord became hubs to talk up trades, sometimes helping send shares of companies on a wild ride.

Some investors, including prominent figures such as Dave Portnoy, used the spaces to tout gains and lament losses. Mr. Portnoy, founder of the popular digital media company Barstool Sports Inc., began streaming trades to his followers, who now approach two million, on Twitter. "Stocks only go up," Mr. Portnoy would proclaim, reiterating the phrase that had become popular on internet messaging forums.

For a while, as stocks zoomed higher, the mantra seemed to hold up. Three months after markets bottomed in March, shares of companies from Moderna Inc. to Tesla Inc. to Peloton Interactive Inc. had all jumped 130% or more. Individual investors piled into those stocks while snatching up shares of smaller companies, too. Perhaps most notoriously, they sent shares of companies including Hertz Global Holdings Inc. and Chesapeake Energy Corp. soaring, despite the financial crises the companies faced. The companies, both of which filed for bankruptcy protection, were ultimately delisted from the New York Stock Exchange.

On peak trading days in 2020, individual traders are estimated to have accounted for nearly 25% of U.S. trading activity, Citadel Securities estimates. Overall, their share of total trading volume doubled to an average of 20% from 10% in 2019, Citadel said.

Analysts say individual traders likely make their biggest impact in driving share prices of smaller or less-popular companies, though they remain robust buyers of the same megacap **technology** companies and other stocks that institutional investors own. Webull Financial LLC said Tesla and Apple Inc. were the most popular stocks on its trading platform in 2020. TD Ameritrade pointed to Amazon.com Inc. and PayPal Holdings Inc. as among the most heavily purchased companies during November.

Retail platforms -- Robinhood, in particular -- have become the subject of increasing scrutiny. In December, Massachusetts regulators filed a complaint against the company, saying it failed to protect users' assets and encouraged inexperienced customers to make risky trades. Robinhood, which disputes the allegations, says it has added safeguards for options trading, which is generally considered to be a more complicated -- and at times riskier -- strategy. It also maintains that only 13% of users who traded in any given month in 2020 made an options bet.

"We see evidence that many of our customers are classic 'buy and hold' investors," said Vlad Tenev, Robinhood's CEO.

Robinhood in May said that the number of users of its platform had reached more than 13 million. Analysts believe that number is now higher. The app popularized free trading, thanks, in part, to its mobile-first, easy-to-use platform and the promise of free stocks when signing up or referring friends to join.

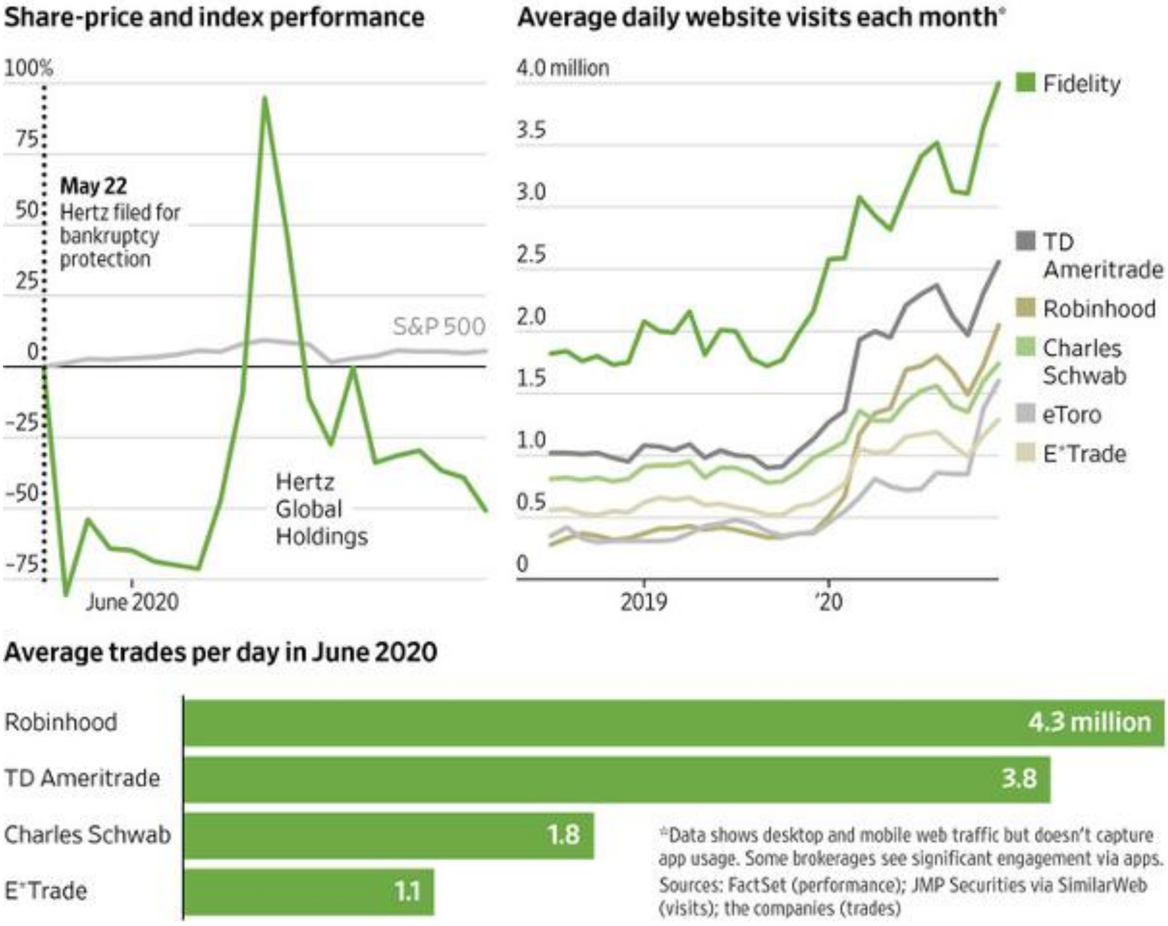
Despite the attention on the riskier trades that investors executed, studies have found individual investors performed well in 2020. A June note from Goldman Sachs Group Inc. analysts found that a basket of the stocks most popular among individual investors had outperformed hedge-fund and mutual-fund favorites -- as well as the broader market -- since the March lows, due to individual traders' quicker embrace of value stocks. Other analyses from researchers similarly found that individual investors didn't significantly panic when markets tumbled in 2020, which rewarded them when stocks began rising.

Although a debate about the risks and rewards that online brokerages enable is likely to continue, few analysts or financial advisers argue that enticing people to begin investing earlier is a bad thing. Studies have repeatedly shown that investing early can lead to bigger gains later in life. The recent introduction by online brokerages of tools such as fractional investing -- or the ability to buy just a portion of a share -- has made trading big-name companies more accessible, too.

The past year "created a new generation of investors that are seeking more," Mr. Ryan of JMP Securities said. "They want tools, they want education, they want to do more."

Mr. Ryan noted that significant growth opportunities for brokerages are possible, especially if they continue to expand their product offerings. The ability to capture investors' wallets while they are young, and then work to become the main financial relationship in their lives via trading, banking, wealth management and other services offers some firms significant potential, he said.

"If you think about the customer today, I think there's a lot of attention on their small accounts," he said. "But these are small accounts today that in 20 years could be very large accounts."



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