NOTE

STEALING FROM THE POOR: REGULATING ROBINHOOD'S EXCHANGE-TRADED OPTIONS FOR RETAIL INVESTORS

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During the height of the COVID-19 pandemic, Robinhood, a brokerage-free stock trading app, saw a meteoric rise in account holders, with Americans seeking new income streams during times of economic hardship, unemployment, and, at times, sheer boredom.[1] The ensuing trading activity significantly impacted the country's stock market—a result of not only Robinhood's three million new accounts[2] but also their investment in complex financial instruments known as exchange-traded options.[3] Notably, several stocks experienced seemingly illogical price and trading volume increases, leading to unsustainable price bubbles, dramatic increases in price volatility, and eventually crashes.[4] Robinhood's options trading platform was the primary vehicle for this trad-

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1 Rob Walker, *How Robinhood Convinced Millennials to Trade Their Way Through a Pandemic*, MARKER (June 1, 2020), https://marker.medium.com/how-robinhood-convinced-millennials-to-trade-their-way-through-a-pandemic-1a1db97c7e08 [https://perma.cc/QT67-G9KB].

2 Matt Egan, *This Market Mayhem Will Test Robinhood's Newbie Investors*, CNN BUS. (Sept. 4, 2020), https://www.cnn.com/2020/09/04/investing/stock-market-robinhood-nasdaq/index.html [https://perma.cc/ZD3Z-8T3M].

3 Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes with Devastating Results*, N.Y. TIMES (July 8, 2020), https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html [https://perma.cc/WTH8-3XQ6] (last updated July 21, 2021).

4 Maggie Fitzgerald, *Penny Stock-Loving Robinhood Traders Raised Bubble Concerns, but Most Retail Investors Are Selling*, CNBC (June 25, 2020), https://www.cnbc.com/2020/06/25/penny-stock-loving-robinhood-traders-raised-bubble-concerns-but-most-retail-investors-are-selling.html [https://perma.cc/7A27-J43K]; Ben White & Aubree Eliza Weaver, *Meme Stocks Come Crashing Down*, POLITICO: MORNING MONEY (Feb. 3, 2021), https://www.politico.com/newsletters/morning-money/2021/02/03/meme-stocks-come-crashing-down-793142 [https://perma.cc/X9MN-2TTY].

ing activity,[5] allowing investors to trade beyond their financial means, or perhaps more aptly, gamble on future prices. The trading activity highlighted two significant problems with allowing retail investors to invest in exchange-traded options: their failure to fundamentally comprehend the financial instrument and, consequently, their significant losses.

Numerous regulatory responses may address these problems, each focusing on a potential contributing level: (1) retail investors; (2) the exchange-traded option; and (3) Robinhood. This Note aims to analyze five potential responses, ranging from least interventionist to most: increasing mandatory disclosure requirements, product regulation, conduct regulation of Robinhood as a broker-dealer, conduct regulation of Robinhood as a trading platform, and restriction of access to the product by retail investors. While each of these options has its inherent benefits and costs, this Note ultimately advocates that the appropriate response to curb Robinhood options trading by retail investors is to regulate Robinhood's conduct as a trading platform by establishing affirmative duties on it that seek to protect its retail customer base, particularly in light of the nature and structure of its execution of trades orders from clients.

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5 Walker, *supra* note 1.

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INTRODUCTION

On May 22, 2020, Hertz, the country's second-largest car rental agency, filed for Chapter 11 bankruptcy, with the COVID-19 pandemic freezing travel and in turn stemming the company's major source of income.[6] With its fleet of rental cars gathering dust, Hertz was unable to meet its vehicle lease payments, and its share price crashed immediately following its bankruptcy filing—the company's largest shareholder dumping 55.3 million shares at a multibillion-dollar loss.[7] Despite now being an essentially valueless equity, from May 26 to June 8, Hertz's stock rose back from 56 cents per share to $5.53, gaining over 800%.[8] It was reported that 122,000 Robinhood accounts had purchased Hertz shares in the intervening period,[9] with significant holdings in exchange-traded options.[10] These new holdings had been purchased despite the now bankrupt Hertz experiencing no significant change in its bankruptcy status nor Chapter 11 proceedings to suggest that

6 Kelly Anne Smith, *Robinhood & Hertz: The Troubling Saga of a Bankrupt Stock*, FORBES: ADVISOR (June 24, 2020), https://www.forbes.com/advisor/investing/robinhood-bankrupt-hertz/ [https://perma.cc/5D4F-WG4M].

7 *Id.*

8 *Id.*

9 Sarah Ponczek & Vildana Hajric, *Hundreds of Thousands of Tiny Buyers Are Swarming to Insolvency Stocks in Get-Rich-Quick Play*, FIN. POST (June 9, 2020), https://financialpost.com/investing/hundreds-of-thousands-of-tiny-buyers-swarm-to-insolvency-stocks [https://perma.cc/FY2N-2YCV].

10 *See* Matt Levine, *The Bad Stocks Are the Most Fun*, BLOOMBERG: OPINION (June 9, 2020), https://www.bloomberg.com/opinion/articles/2020-06-09/the-bad-stocks-are-the-most-fun [https://perma.cc/8BNL-9VUP] ("Traders established fresh bullish positions last week by buying 35.6 million new call options on equities . . . ."); Sarah Ponczek & Vildana Hajric, *Robinhood Market Made Bursting Bubbles Wall Street's Obsession*, BLOOMBERG: OPINION (June 13, 2020), https://www.bloomberg.com/news/articles/2020-06-13/robinhood-market-made-bursting-bubbles-wall-street-s-obsession [https://perma.cc/P7MR-UW6C] ("The smallest of traders [$2,000 or less in investment] bought more than 14 million speculative call options in the week ended June 5 . . . ."); Dana Sanchez, *Speculative Robinhood Traders Are Buying Call Options at 2000 Crash-Record Levels, Pushing Stocks Up*, MOGULDOM NATION (June 9, 2020), https://moguldom.com/284599/speculative-robinhood-traders-are-buying-call-options-at-2000-crash-record-levels-pushing-stocks-up/ [https://perma.cc/V2QJ-DPYU].

any long-term value could be recognized,[11] let alone a change that would justify a share price increase of 800%. More importantly, a bankrupt company must pay its creditors with any remaining assets before any residual (often none) is paid out to its shareholders.[12]

During the height of the COVID-19 pandemic, Robinhood, the largest brokerage-free stock trading app, gained over three million new accounts,[13] with Americans looking for new income streams and forms of entertainment, given widespread unemployment, furloughs, and the global shutdown of casinos and halt in professional sports.[14] Over the past year, several notable stocks have experienced what appear to be illogical increases in price and trading volume—most notably: Tesla, Eastman Kodak, and Hertz.[15] Yet these drastic price increases were not without consequences—they created unsustainable price bubbles, dramatic increases in volatility, and eventually, crashes.

New speculative retail investors were able to trade these companies' stocks and in turn be exposed to their price movements, largely through Robinhood, trading either in the company's equity shares or, more worrisome, options contracts. This Note aims to explore the latter form of trading, which poses considerably more problems for retail investors due to the financial instrument's inherent complexity, its significant price volatility, and its executory contract structure, which all subject an investor to significant potential downside losses. Exchange-traded options, as a financial instrument, are discussed in Part II. As a result of their relative lack of experience

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11 Jeremy Hill & Steven Church, *Retail Traders Flout Legal Logic by Buying Up Bankrupt Stocks*, BLOOMBERG (June 8, 2020), https://www.bloomberg.com/news/articles/2020-06-08/retail-traders-flout-legal-logic-in-dash-for-bankrupt-stocks?sref=VUYGislZ [https://perma.cc/5WAA-LGLP].

12 *Id.*

13 Egan, *supra* note 2; *see also* Avi Salzman, *Robinhood Added Over 1 Million Accounts During GameStop Turmoil, Report Estimates*, BARRON'S (Feb. 1, 2021), https://www.barrons.com/articles/robinhood-added-over-1-million-accounts-during-gamestop-turmoil-report-estimates-51612197641 [https://perma.cc/YQE7-RS2A] (noting that Robinhood app downloads in January 2021 was likely a record for any broker in history).

14 *See* Justin Birnbaum, *In the Coronavirus Sports Void, These Are the Desperate Bets Gamblers Are Making*, CNBC (Mar. 21, 2020), https://www.cnbc.com/2020/03/21/coronavirus-and-sports-what-gamblers-are-betting-on-in-the-void.html [https://perma.cc/585Y-97G6].

15 Egan, *supra* note 2; Cristin Flanagan, Esha Dey & Jennifer Bissell-Linsk, *Year of the Meme Stock: Hertz, Kodak Top List of 2020 Highlights*, BLOOMBERG (Dec. 26, 2020), https://www.bloomberg.com/news/articles/2020-12-26/year-of-the-meme-stock-hertz-kodak-top-list-of-2020-highlights [https://perma.cc/766C-Y89L].

and comparatively low net worth, retail investors are particularly prone to incurring life-changing significant losses, especially given that they appear to suffer a fundamental misunderstanding of options trading, which leads them to trade beyond their means. The inherent problems faced by retail investors trading in derivatives is discussed in Part III. The problematic exchange-traded options activity during the height of the COVID-19 pandemic calls for an appropriate regulatory response in order to adequately protect retail investors from themselves. This Note explores five potential regulatory responses available to the SEC, aiming to target one of the three levels to this problem: the retail investors, the exchange-traded option financial instrument, and Robinhood. Ranging from least interventionist to most, this Note explores the following regulatory responses: (1) disclosure, aimed at the retail investors, in subpart IV.A.; (2) product regulation, aimed at the exchange-traded option instrument, in subpart IV.B.; (3) conduct regulation, aimed at Robinhood, in subpart IV.C. and IV.D.; and (4) restriction of access, aimed at both the retail investors and Robinhood, in subpart IV.E. In exploring each of these responses, this Note seeks to explain their general operation, how they may be applied to the specific Robinhood options trading scenario, and their benefits and costs—specifically with reference to their potential to curb retail investor options trading without encroaching more generally on the freedom of contract and imposing additional costs on private actors—namely investors and broker-dealers—as well as potential public costs faced by society at large.

I
ROBINHOOD AND THE COVID-19 PANDEMIC

A. Robinhood

A product of Silicon Valley's start-up market,[16] Robinhood describes itself as a registered broker-dealer under FINRA that "provides online and mobile application-based discount stock brokerage services to self-directed investors,"[17] with a mission

[16] Nathaniel Popper, Matt Phillips, Kate Kelly & Tara Siegel Bernard, *The Silicon Valley Start-Up That Caused Wall Street Chaos*, N.Y. TIMES (Jan. 30, 2021), https://www.nytimes.com/2021/01/30/business/robinhood-wall-street-gamestop.html [https://perma.cc/YNE5-E7UR].

[17] ROBINHOOD, ROBINHOOD TERMS & CONDITIONS [hereinafter ROBINHOOD TERMS & CONDITIONS], https://cdn.robinhood.com/assets/robinhood/legal/Robinhood%20Terms%20and%20Conditions.pdf [https://perma.cc/QEF9-GS4V] (last visited Oct. 29, 2020) ("Robinhood . . . provides online and mobile

to "democratize finance."[18] A broker-dealer, under the Securities Exchange Act of 1934, is any person "engaged in the business of effecting transactions in securities for the account of others"[19] and "the business of buying and selling securities . . . for such person's own account . . . ."[20] As a broker-dealer, Robinhood is subject to numerous regulatory requirements, explored in subpart IV.C. of this Note.

There is no minimum deposit required to open a Robinhood trading account, nor are there trading and brokerage fees for its customers.[21] Robinhood has become infamous for its gamified app-based trading platform[22] and helping pioneer the commission-free trading movement in the United States,[23] which has ultimately given it "unicorn" status amongst the fintech industry.[24] In turn, Robinhood's platform has expanded into more complex and highly volatile financial

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application-based discount stock brokerage services to *self-directed investors*." (emphasis added)).

18 ROBINHOOD, OUR MISSION [hereinafter ROBINHOOD MISSION], https://robinhood.com/us/en/support/articles/our-mission/ [https://perma.cc/VAK6-GPQM] (last visited Oct. 29, 2020).

19 Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (2018).

20 Securities Exchange Act of 1934 § 3(a)(5), 15 U.S.C. § 78c(a)(5) (2018).

21 Janet Morrissey, *With No Frills and No Commissions, Robinhood App Takes on Big Brokerages*, N.Y. TIMES (Feb. 18, 2017), https://www.nytimes.com/2017/02/18/business/robinhood-stock-trading-app.html [https://perma.cc/KL4E-BBB7]. *But see* Logan Kane, *Robinhood Is Making Millions Selling Out Their Millennial Customers to High-Frequency Traders*, SEEKING ALPHA (Sept. 10, 2018), https://seekingalpha.com/article/4205379-robinhood-is-making-millions-selling-out-millennial-customers-to-high-frequency-traders [https://perma.cc/4892-D5D5] (explaining that Robinhood profits millions of dollars from selling their customers' order to high frequency trading firms, who then route those order to exchanges).

22 *See* Scott Galloway, *Robinhood Has Gamified Online Trading into an Addiction*, MARKER (June 23, 2020), https://marker.medium.com/robinhood-has-gamified-online-trading-into-an-addiction-cc1d7d989b0c [https://perma.cc/Y6HV-JCPB]; Caitlyn McConnell, *Robinhood and the Gamification of the Stock Market*, MCGILL BUS. REV. (July 29, 2020), https://mcgillbusinessreview.com/articles/robinhood-and-the-gamification-of-the-stock-market [https://perma.cc/SV7T-8TJE].

23 Tim Fernholz, *How No-Fee Stock Trading Is Changing the Stock Market*, QUARTZ (Sept. 22, 2020), https://qz.com/1906670/how-robinhoods-no-fee-stock-trading-is-changing-the-stock-market/ [https://perma.cc/V3QC-QATF].

24 William U. Morales, *Blueprint of a Fintech Unicorn: Robinhood*, MEDIUM (July 29, 2020), https://medium.com/fintechtris/blueprint-of-a-fintech-unicorn-robinhood-fe7d4de8c93b [https://perma.cc/U53B-LD3P].

instruments such as options[25] and cryptocurrency,[26] usually reserved for experienced investors.[27] As a market leader with "over 50% of the market share of new brokerage accounts"[28] and allegedly approximately 13 million accounts totaling $20 billion dollars in assets under management,[29] Robinhood's success has reached a point where it appears due for an initial public offering in 2021.[30]

Robinhood's gamified app-based trading platform warrants specific explanation here, especially in the context of the retail investor users during the pandemic. When users sign up for the platform, they receive a free stock,[31] emblematic of Robinhood's overall mission to democratize finance.[32] The free stock is announced to users via a burst of virtual confetti and flashing red and green lights.[33] The same confetti celebration appears after users make an initial deposit into their Robinhood accounts, appears again when they make their first trade, regardless of whether it is ultimately profitable, and reappears after numerous "first" actions.[34] When trades are

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25 *See* Alicia Adamczyk, *Trading Apps Like Robinhood Are Having a Moment. But Users Should Be Careful*, CNBC (Aug. 21, 2020), https://www.cnbc.com/2020/08/21/robinhood-is-having-a-moment-users-should-be-careful.html [https://perma.cc/WUG5-L5ZJ] (last updated Aug. 24, 2020); Annie Massa & Sophie Alexander, *Robinhood's New Traders Ignore Danger Signs to Bet on Stocks*, BLOOMBERG (June 19, 2020), https://www.bloomberg.com/news/articles/2020-06-19/robinhood-s-newbie-traders-ignore-danger-signs-to-bet-on-markets [https://perma.cc/3TH8-WR7R].

26 Morales, *supra* note 24.

27 Paul Sullivan, *As Bitcoin's Price Surges, Affluent Investors Start to Take a Look*, N.Y. TIMES (Jan. 29, 2021), https://www.nytimes.com/2021/01/29/your-money/bitcoin-wealth-investors.html [https://perma.cc/CVN3-76C2] (last updated Jan. 31, 2021).

28 Walker, *supra* note 1.

29 *Robinhood Assets Under Management (AUM) in 2021*, BROKERAGE-REVIEW.COM, https://www.brokerage-review.com/investing-firm/assets-under-management/robinhood-aum.aspx [https://perma.cc/DP68-XHSJ] (last visited May 2, 2021).

30 Crystal Tse & Scott Deveau, *Robinhood Seeks Advisers for Potential IPO Next Year*, BLOOMBERG (Nov. 17, 2020), https://www.bloomberg.com/news/articles/2020-11-17/robinhood-is-said-to-seek-advisers-for-potential-ipo-next-year [https://perma.cc/9WFT-Y8GF] (last updated Nov. 18, 2020).

31 ROBINHOOD, OPEN ACCOUNT, GET FREE STOCK, https://robinhood.com/us/en/support/articles/open-account-get-free-stock/ [https://perma.cc/7A4C-ZEKS] (last visited May 2, 2021).

32 ROBINHOOD MISSION, *supra* note 18.

33 Christine Ji, *A Critique of Robinhood's Gamified Interface*, GEO. COLLEGIATE INVS. (Aug. 7, 2020), https://www.georgetowninvest.com/blog/a-critique-of-robinhoods-gamified-interface [https://perma.cc/8JVM-SA4B]; Galloway, *supra* note 22.

34 *See* Michael Wursthorn & Euirim Choi, *Does Robinhood Make It Too Easy to Trade? From Free Stocks to Confetti,* WALL ST. J. (Aug. 20, 2020), https://www.wsj.com/articles/confetti-free-stocks-does-robinhoods-design-make-trad-

completed, which requires only a simple quick swipe,[35] Robinhood also sends users "emoji-laden messages" to entice additional trades and transactions.[36] Likewise, Robinhood maintains daily push notifications of top "Daily Movers"—the stocks most frequently traded on the market through the app for the day—again in emoji-laden messages designed specifically to generate additional trading interest.[37] Perhaps the most indicative of Robinhood's gamified elements involves their premium cash management feature, which is subject to a significant waitlist; users are able to move up this waitlist by tapping inside the application, limited to 1,000 taps per day.[38]

The overall appearance of Robinhood is incredibly unusual for a financial trading platform. It has been described as "Charles Schwab[ ] meet[s] Candy Crush,"[39] and likened to racetrack betting.[40] The stakes and consequences of gamification may be relatively tame in the context of fitness and social media apps, but where the app can serve as an instrument for users to lose their entire retirement savings within a matter of days, the analysis necessarily begs to be different.

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ing-too-easy-11597915801 [https://perma.cc/4DUK-62PU]; Clark Randall, *The Trading App Robinhood Takes from You and Gives to the Rich*, JACOBIN (Jan. 14, 2021), https://www.jacobinmag.com/2021/01/trading-app-robinhood-investors-scams-sec [https://perma.cc/K7XX-4JSK].

35 Annie Massa, Michael McDonald & Sophie Alexander, *Robinhood Is Accused of 'Gamification' by Massachusetts*, BLOOMBERG: QUINT (Dec. 16, 2020), https://www.bloombergquint.com/onweb/robinhood-accused-of-gamification-by-massachusetts-regulator [https://perma.cc/Y2QH-9WB3].

36 Eric Platt & Madison Darbyshire, *Robinhood Faces Legal Action over 'Gamification' of Investing*, FIN. TIMES (Dec. 16, 2020), https://www.ft.com/content/0e451231-fa4c-4686-bf2f-a5e107f337b9 [https://perma.cc/U9JP-5AMU].

37 Hannah Levintova, *Robinhood Promises Free Trades. Did Alex Kearns Pay with His Life?*, MOTHER JONES (Apr. 29, 2021), https://www.motherjones.com/politics/2021/04/robinhood-gamestop-free-trades-alex-kearns/ [https://perma.cc/7KQK-3NR8].

38 Carla Fried, *Finance Apps with 'Gamification' Can Increase Risk*, GUARANTEED RATE (Jan. 19, 2021), https://www.rate.com/research/news/finance-apps-gamification [https://perma.cc/A29X-BK6D].

39 David Ingram, *Designed to Distract: Stock App Robinhood Nudges Users to Take Risks*, NBC NEWS (Sept. 12, 2019), https://www.nbcnews.com/tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071 [https://perma.cc/SXA8-XUNU].

40 Caitlin McCabe & Jason Zweig, *Charlie Munger Renews Robinhood Criticism, Likens App to Racetrack Betting*, WALL ST. J. (Feb. 25, 2021), https://www.wsj.com/articles/charlie-munger-renews-robinhood-criticism-likens-app-to-racetrack-betting-11614284939 [https://perma.cc/Y9G8-UDEZ].

B. Significance of Robinhood during the COVID-19 Pandemic

Robinhood further rose into prominence during the height of the COVID-19 pandemic, reaching record levels of trading volume while the country faced record-high unemployment.[41] Already known for its relatively inexperienced and modest-income customer base,[42] an influx of millions of new accounts during the pandemic seemed to further exacerbate the perils of trading financial instruments beyond new investors' means and understanding. The influx was not restricted to Robinhood's platform: retail trader accounts amongst online broker-dealers grew to account for 20-25% of the entire stock market's trading activity, compared to a 10% historical average.[43] Part of this trading volume increase was driven by the increase in the trading of exchange-traded options[44]—a derivative financial instrument that allows an investor to trade hundreds of shares at a time at significantly lower upfront cost than physically buying those same shares through the use of leverage.[45] Much of the trading activity, some even spurred by social media forums,[46] appeared to resemble an irrational frenzy and over-optimism of the market condition. Most notably, in what is now described as a "bankruptcy bubble,"[47] Robinhood traders were heavily invested in companies such as Hertz,[48] JC Penney,[49] and Whiting Petroleum *after* they had filed for Chapter 11 bankruptcy.[50]

The trading of company shares when that company has filed for Chapter 11 bankruptcy is particularly troubling because shareholders are often last in line to recover their invest-

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41 Adamczyk, *supra* note 25.

42 *See* Morales, *supra* note 24; Popper, *supra* note 3 (Robinhood stated that "[t]he average age [of its customers] is 31 . . . and half of its customers had never invested before.").

43 Egan, *supra* note 2.

44 Popper, *supra* note 3.

45 James Royal, *Put Options: Learn the Basics of Buying and Selling*, BANKRATE (June 15, 2021), https://www.bankrate.com/investing/what-are-put-options-learn-basics-buying-selling/ [https://perma.cc/76TN-G6ZM].

46 Massa & Alexander, *supra* note 25.

47 McConnell, *supra* note 22.

48 Smith, *supra* note 6.

49 Jack Kelly, *A Twitter Army of Aggrieved Shareholders Claim They've Been Taken Advantage of in the J.C. Penney Bankruptcy Proceedings by a 'Rigged System'*, FORBES (Nov. 17, 2020), https://www.forbes.com/sites/jackkelly/2020/11/17/a-twitter-army-of-aggrieved-shareholders-claim-theyve-been-taken-advantage-of-in-the-jc-penney-bankruptcy-proceedings-by-a-rigged-system/?sh=1f01166e4d71 [https://perma.cc/8JXU-J6S3].

50 McConnell, *supra* note 22.

ment and therefore usually receive no payout from a Chapter 11 plan—a plan voted on by aggrieved creditors.[51] Whether this priority calls for greater retail investor protection or simply an alteration of bankruptcy priority rules is debatable,[52] but as bankruptcy laws currently stand, the trading could very much be interpreted as questionable. To explore an example, Hertz, the country's second-largest car rental agency, filed for Chapter 11 bankruptcy on May 22, 2020 as a result of the COVID-19 pandemic crippling the nation's economy and freezing travel.[53] Faced with its rental car fleet failing to generate any income, Hertz was unable to meet its lease payments.[54] Hertz shares drastically fell in price after the bankruptcy filing, with the company's largest shareholder dumping 55.3 million shares into the market at a multibillion-dollar loss.[55] Despite being now a valueless equity, from May 26 to June 8, Hertz's stock rose from 56 cents per share to $5.53, gaining over 800%.[56] It was reported that 122,000 Robinhood accounts had purchased ownership of Hertz shares in some form in the intervening period,[57] with significant holdings in options.[58] It goes without saying again that the irrational investment into Hertz was not exclusively in derivatives; retail investors traded vanilla Hertz shares in the same manner as exchange-traded options.[59] However, the relatively inexpensive upfront costs to enter into options contracts can be particularly misleading in that they expose investors to the price movements of factors of hundreds of shares and can ultimately result in significant losses, most

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51 Hill & Church, *supra* note 11.

52 *See* Anthony J. Casey & Joshua C. Macey, *The Hertz Maneuver (and the Limits of Bankruptcy Law)*, UNIV. CHI. L. REV. ONLINE, Oct. 7, 2020, at *16–22.

53 Smith, *supra* note 6.

54 *Id.*

55 *Id.*

56 *Id.* Similar outcomes were witnessed in the other aforementioned stocks—JC Penney's stock rose by 300% in a few days following its Chapter 11 filing, while Whiting Petroleum's stock rose over 200% directly after the filing. *See* Vuk Vukovic, *Irrational Exuberance and Why You Shouldn't Be Worried*, SEEKING ALPHA (Dec. 1, 2020), https://seekingalpha.com/article/4392269-irrational-exuberance-and-why-you-shouldnt-be-worried [https://perma.cc/9LLL-AWF5].

57 Ponczek & Hajric, *supra* note 9.

58 *See supra* note 10

59 *See* Thomas Franck, *Hertz Says It Expects Stockholders to Lose All Their Money in Filing for Selling More Stock*, CNBC (June 15, 2020), https://www.cnbc.com/2020/06/15/hertz-says-it-expects-stockholders-to-lose-all-their-money-in-filing-for-selling-more-stock.html [https://perma.cc/29P8-CRD3] (discussing the implications of a common stock offering by Hertz during Chapter 11 bankruptcy on its current common stockholders who had purchased during the COVID-19 pandemic).

likely well beyond the financial means of many investors, especially retail investors.[60]

The negative consequences of retail investors' increased trading activity during the pandemic were two-fold. Firstly, they created significant price bubbles for essentially valueless shares driven almost solely by their demand, rather than the underlying values of the company. These price bubbles also may not have been limited to only a few bankrupt companies. Instead, the coronavirus stock market has been described itself as a "bubble"[61]—evidenced by the S&P 500's almost complete recovery amidst lockdown and stay-at-home orders.[62] Secondly, and more pointedly, these significant losses have had tragic outcomes for individual retail investors, laden with debts well beyond their means, and have led to traumatic events. Robinhood's specific infamy, relative to its peer online trading platforms, has largely been attributed to its trading platform's heavily gamified appearance, increasingly likening the trading experience to gambling[63] and often being labelled as addictive.[64] This recipe for disaster has led to numerous high profile significant losses for many Robinhood users, already desperate to make financial ends meet during the COVID-19 pandemic.[65]

It is worthwhile mentioning here that these events repeated themselves almost tenfold in January 2021 in what can only be described as a "frenzy" with the stock of GameStop.[66] Over the month of January, GameStop rose nearly 3,000%,[67] from $65

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60 *See* Royal, *supra* note 45 ("[S]elling a call option exposes you to uncapped losses (since a stock can rise to any price but cannot fall below $0).").

61 Fitzgerald, *supra* note 4.

62 Gunjan Banerji, *Why Did Stock Markets Rebound from Covid in Record Time? Here Are Five Reasons*, WALL ST. J. (Sept. 15, 2020), https://www.wsj.com/articles/why-did-stock-markets-rebound-from-covid-in-record-time-here-are-five-reasons-11600182704 [https://perma.cc/ZW42-67GP]; *see also* Josh Zumbrun, *Coronavirus Slump Is Worst Since Great Depression. Will It Be As Painful?*, WALL ST. J. (May 10, 2020), https://www.wsj.com/articles/coronavirus-slump-is-worst-since-great-depression-will-it-be-as-painful-11589115601 [https://perma.cc/3KHR-WJ6E] (explaining why the effects of the current economic downturn are likely to be much shorter and less severe than those of the great depression, despite the similar global scale).

63 McConnell, *supra* note 22.

64 *Id.*

65 *See, e.g.*, Popper, *supra* note 3 (noting that a college student in Nebraska had committed suicide "after he logged into the app and saw that his balance had dropped to negative $730,000"); Massa & Alexander, *supra* note 25 (same).

66 Aimee Picchi, *Robinhood CEO, Hedge Fund Execs Defend Their Role in GameStop Frenzy*, CBS NEWS (Feb. 19, 2021), https://www.cbsnews.com/news/gamestop-robinhood-vlad-tenev-house-hearing/ [https://perma.cc/5P6A-9NZ6].

67 *Id.*

per share to an intraday peak of $483,[68] based almost purely on spite for the derivatives trading activity of Melvin Capital, a multi-billion-dollar hedge fund.[69] For the purposes of this Note, the GameStop frenzy is not dissimilar from the significant trading activity of companies in the midst of Chapter 11 proceedings. Rather than trading stocks or even their riskier sibling, exchange-traded options, on the basis of fundamental and future value, trading activity involving GameStop appeared to be driven by disdain for Wall Street actors and a love-hate relationship with America's largest video game retailer.[70] Retail investors trading options in GameStop were effectively pitting themselves directly against hedge funds in an active price war. Unlike earlier trading during the "bankruptcy bubble,"[71] the GameStop episode forced Robinhood intervention: purchase restrictions were placed by the trading platform on "meme stocks"[72] amidst Robinhood's clearinghouse, the entity responsible for settling all of these orders, requesting an additional $3 billion in collateral should these open trades in exchange-traded options be required to settle at their existing valuation.[73] The GameStop frenzy catapulted Robinhood, r/WallStreetBets, and the arguably irrational trading by retail investors into the national media spotlight, raising concerns from the Securities and Exchange Commission about the long-term financial market stability effects and perceived market manipulation.[74]

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68 Nathaniel Popper & Matt Phillips, *In GameStop Saga, Robinhood Is Cast as the Villain*, N.Y. TIMES (Feb. 18, 2021), https://www.nytimes.com/2021/02/18/business/gamestop-robinhood-hearing.html [https://perma.cc/S6KQ-MXV4].

69 Svea Herbst-Bayliss, *Melvin Capital Ends Month with over $8 Billion in Assets After Investors Added Cash: Source*, REUTERS (Jan. 31, 2021), https://www.reuters.com/article/us-retail-trading-melvin/melvin-capital-ends-month-with-over-8-billion-in-assets-after-investors-added-cash-source-idUSKBN2A00KW [https://perma.cc/YN6G-5RMD].

70 Ben Gilbert, *The World's Biggest Video Game Retailer, GameStop, Is Dying: Here's What Led to the Retail Giant's Slow Demise*, BUS. INSIDER (Jan. 23, 2020), https://www.businessinsider.com/gamestop-worlds-biggest-video-game-retailer-decline-explained-2019-7 [https://perma.cc/F6WU-L3D9].

71 McConnell, *supra* note 22.

72 Flanagan, Dey & Bissell-Linsk, *supra* note 15.

73 Jeff John Roberts, *The Real Story Behind Robinhood's Decision to Restrict GameStop Trading—And That 4 a.m. Call to Put up $3 Billion*, FORTUNE (Feb. 2, 2021), https://fortune.com/2021/02/02/robinhood-gamestop-restricted-trading-meme-stocks-gme-amc-vlad-tenev-nscc/ [https://perma.cc/S2S2-3LZG].

74 *See* Elizabeth Lopatto, *How R/WallStreetBets Gamed the Stock of GameStop*, VERGE (Jan. 27, 2021), https://www.theverge.com/22251427/reddit-gamestop-stock-short-wallstreetbets-robinhood-wall-street [https://perma.cc/V6JH-LVJE].

II
EXCHANGE-TRADED OPTIONS

An options contract represents one of the fundamental building blocks of all financial derivatives contracts; it gives the holder the *right* or *option*, but not the *obligation*, to purchase or sell an underlying asset in the future at a price—the *exercise* or *strike price*—determined today.[75] The right to purchase an underlying asset at the exercise price is described as a *call* option, while the right to sell an underlying asset at the exercise price is described as a *put* option.[76] The holder of an option contract can also choose to "forego [their] right of exercise and let the option expire."[77] This arrangement is not completely to the benefit of the option contract holder because the counterparty—the option writer—charges a premium for taking on the obligation to sell or purchase the underlying asset if the holder chooses to exercise their right.[78] That being said, the option premium represents the small upfront cost of entering the contract—it does not encompass the complete cost of the option contract, which instead is subject to the price movements of the underlying asset in relation to the exercise price.[79] These price movements also highlight an additional cost of entering options contracts: the concept of margin—the contractual obligation to maintain collateral between the counterparties, designed to cover any payments that become due based off the difference between exercise price and the current market price.[80] At their core, all derivatives are more or less bets on the future, either on a certain price of the underlying asset or the occurrence of some specific event.[81] Because they are based on future events, option contracts are executory in nature—they require performance of obligations over a po-

75 Dan Awrey, *Split Derivatives: Inside the World's Most Misunderstood Contract*, 36 YALE J. ON REGUL. 495, 504 (2019).

76 *Id.*

77 Carolyn H. Jackson, Note, *Have You Hedged Today? The Inevitable Advent of Consumer Derivatives*, 67 FORDHAM L. REV. 3205, 3212 (1999).

78 Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. UNIV. CHI. L.J. 1, 23 (2011).

79 *See* Dan Awrey, *The Mechanisms of Derivatives Market Efficiency*, 91 N.Y.U. L. REV. 1104, 1126 (2016) ("[O]ne of the core features of derivatives is their status as 'neoclassical' executory contracts that contemplate the performance of obligations by one or both traders over time."); Royal, *supra* note 45 ("[F]or a small upfront cost, a trader can profit from stock prices below the strike price until the option expires.").

80 Lynch, *supra* note 78, at 33.

81 Suzanne E. Bish, *A Guide to Narrow the Derivatives' Understanding Gap and Reduce Losses: How to Increase Knowledge, Controls, and Reporting*, 58 OHIO ST. L.J. 539, 541 (1997).

tentially significant period of time.[82] Option contracts can last anywhere between a day and multiple years, with popular contract lengths being weeks and months.[83]

Exchange-traded options are simply those options contracts that are traded on exchanges, such as the Chicago Board of Trade.[84] An exchange-traded option features highly standardized features, with investors often only being able to choose the predetermined expiration date and, by extension, the exercise price.[85] Further, it is important to note here that the regulation of options is divided between the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"), depending on the underlying asset.[86] Options on shares, like Robinhood options, are regulated by the SEC, while options on futures and commodities otherwise outside the purview of the SEC are regulated by the CFTC.[87]

The excessive exchange-traded options trading activity by retail investors during COVID-19 has highlighted certain aspects of options that have likely contributed to significant losses. The executory nature of the financial instrument, imposing ongoing costs on the investor as the price of the underlying asset, appears to be misunderstood or at least not adequately considered by retail investors. Relatedly, the financial instrument's significant price volatility and, in turn, its potential for both substantial profits and losses raise significant risks for retail investors who pursue astronomical gains but risk losing significant sums of their money in doing so, losses that are often beyond their means.

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82 Awrey, *supra* note 79, at 1108.

83 *What Is Expiration Date (Expiry)?*, CHI. MERCANTILE EXCH. GRP., https://www.cmegroup.com/education/courses/introduction-to-options/what-is-expiration-date-expiry.html [https://perma.cc/GNQ2-AR3F] (last visited Dec. 11, 2020).

84 Lynch, *supra* note 78, at 30.

85 *Id;* James Chen, *Expiration Date (Derivatives)*, INVESTOPEDIA (Mar. 30, 2021), *https://www.investopedia.com/terms/e/expirationdate.asp* [https://perma.cc/L3DA-S4ST]; Barclay Palmer, *How Long Is an Options Expiration Cycle?*, INVESTOPEDIA (Jan. 29, 2022), https://www.investopedia.com/articles/optioninvestor/03/090303.asp ("Deciding to trade a stock option requires choosing an expiration date. . . . The expiration month you choose will have a significant impact on the potential success of any trade.").

86 Roberta Romano, *The Political Dynamics of Derivatives Securities Regulation*, 14 YALE J. ON REGUL. 279, 282 (1997).

87 *Id.*

III
THE PROBLEM WITH RETAIL INVESTORS AND DERIVATIVES

The baseline for all financial market regulation is the general freedom of contract, with the underlying premise that government intervention should be avoided, absent a compelling reason, such as high social costs.[88] Derivatives are indubitably highly complex financial instruments,[89] and their complexity, at least initially, suggests that they may be appropriate only for sophisticated investors or at least those that fully comprehend the risks involved. Their complexity arises from a number of aspects—namely their executory contract nature, their margin and mark-to-market function, as well as the relation, or lack thereof between their upfront costs, the option premium, and the total potential costs should the option contract end up not being profitable.[90]

Retail investors are prone to suffering from two shortfalls that suggest derivatives may not be an appropriate financial instrument for them: shrouded price equilibriums and bounded rationality.[91] Shrouded price equilibriums refer to a product's "hidden" add-ons that may not be considered during the purchase of the product and thus may fail to be factored into the purchase price.[92] Shrouded price equilibriums are especially prevalent in the context of exchange-traded options, where the upfront option premium charge to initially enter the contract is not completely reflective of the potential total cost of the financial derivative. Relatedly, bounded rationality refers to a consumer's inherent limited ability to process informa-

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88 *See, e.g.*, Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 669 (2010) (noting that reforms should consider the "potential role of industry self-regulation as a key mechanism of controlling and minimizing systemic risk," which has at least two significant potential advantages over government regulation).

89 Awrey, *supra* note 75, at 503.

90 *See supra* note 79; Christoph Burgard & Mats Kjaer, *Partial Differential Equation Representations of Derivatives with Bilateral Counterparty Risk and Funding Costs*, 7 J. CREDIT RISK 75, 76 (2011) (noting the risk of a "counterparty . . . default[ing] while owing money under the terms of a derivative contract" as a product of the "mark-to-market value of the derivative").

91 *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. UNIV. L.Q. 417, 432 (2003); Robert P. Bartlett, III, *Inefficiencies in the Information Thicket: A Case Study of Derivative Disclosures During the Financial Crisis* 4 (U.C. Berkeley, Research Paper No. 1585953, 2010).

92 Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505, 505–506 (2006).

tion.[93] Exchange-traded options again, given their complexity, likely exceed the bounded rationality of retail investors at least partially because of the shrouded price equilibrium shortfall.

Additionally, studies have indicated that where options trading has had a detrimental impact on individual investor performance, these losses have been attributed to bad market timing and an overreaction to past stock market movements as well as over-trading resulting in high trading costs.[94] Here, the timely Chapter 11 filings of multiple bankrupt companies during COVID-19, whilst Robinhood accounts grew substantially and new retail investors entered the market, presented at times a fateful opportunity for over-investment in options and underlying equities that were functionally valueless. The consequent share price increase and resulting price bubble in turn were likely a product of demand alone and potentially an overreaction to the incredibly low share price of recognizable household brands.

Further, "entertainment" and "sensation-seeking" have been identified by retail investors as significant reasons for trading options.[95] This, in combination with the findings that the more often an investor trades, the worse their returns are likely to be,[96] presents a troubling scenario. Holding all else equal, an "entertainment"-seeking retail investor is inclined to trade as many times as possible to maximize their entertainment value, despite the fact that this may also increase the likelihood for negative returns. While the problem illustrated earlier may be attributed to a fundamental lack of comprehension, the scenario here suggests significant government intervention is required not only to inform retail investors so they trade rationally but also to adequately protect from themselves those retail investors that trade in exchange-traded options motivated by entertainment and sensation. It has also been established that retail investors trading in derivatives underperform a diversified investment portfolio that consists of similar underlying stocks, raising the question as to whether access to derivatives by retail investors is at all beneficial[97] or

93 Paredes, *supra* note 91, at 431–32.

94 Rob Bauer, Mathijs Cosemans & Piet Eichholtz, *Option Trading and Individual Investor Performance*, 33 J. BANKING & FIN. 731, 738, 745 (2009).

95 *Id.* at 743.

96 *Id.* at 742.

97 David Nicolaus, Derivative Choices of Retail Investors: Evidence from Germany 4 (Dec. 16, 2010) (unpublished manuscript) (available at https://www.researchgate.net/publication/228291134_Derivative_Choices_of_Retail_Investors_Evidence_from_Germany).

even necessary, given they maintain ample access to equity securities markets.

Ultimately, there appear to be at least two fundamental reasons why retail investors should be restricted from investing in derivatives: (1) a lack of complete understanding and (2) negative externalities. On one hand, retail investors' inherent lack of understanding of financial derivatives is driven by both a stark information asymmetry between the investor and the dealer[98] but also misunderstood fundamental features of the instrument itself.[99] This shortfall may potentially be addressed by increasing the information available to retail investors, or otherwise informing them. One potential regulatory response—increasing mandatory disclosure requirements—attempts to resolve this exact shortfall. On the other hand, the negative externalities issue is grounded in the psychological aspect of gambling and risk-taking[100]—the notion of pure speculative trading at its core—and likely calls for much more significant government intervention. That is, if providing the necessary information to retail investors to ensure they are informed is ineffective, it may be necessary to impose even greater restrictions so as to prevent their trading activity completely, as a means of adequately protecting them from harming themselves. The remaining three regulatory responses—product regulation, conduct regulation, and restriction of access—attempt to resolve this shortfall.

IV
APPROPRIATE REGULATORY RESPONSES

The previous analysis of problematic Robinhood options trading during COVID-19 presents three distinct levels of potential regulatory responses: (1) Robinhood options traders, specifically retail investors; (2) exchange-traded options—that is, the actual financial derivatives instrument; and (3) Robinhood itself as the registered broker-dealer under the purview of the SEC as well as its self-regulatory organization FINRA. While each proposed regulatory response inherently

98 Kevin Smith, Asymmetric Risk Information and Derivative Markets 3 (Feb. 27, 2017) (unpublished manuscript) (available at https://jacobslevycenter.wharton.upenn.edu/wp-content/uploads/2017/08/Asymmetric-Risk-Information-and-Derivative-Markets.pdf [https://perma.cc/GE4U-76QK]).

99 Awrey, *supra* note 75, at 496.

100 *See generally*, Christine Hurt, *Regulating Public Morals and Private Markets: Online Securities Trading, Internet Gambling, and the Speculation Paradox*, 86 B.U. L. REV. 371 (2006) (comparing the speculative nature of online securities trading to gambling).

focuses on one of these levels, it goes without saying that the primary root causes of the problematic options trading—and in turn, the ultimate targets of regulation—remain the fundamental lack of comprehension of financial derivatives by retail investors and, consequently, the significant losses incurred by these retail investors in trading beyond their means. Further, the proposed regulatory responses are by no means mutually exclusive—it may be necessary for a combination of these responses to be implemented to ensure retail investors are sufficiently protected. Ranging from least interventionist to most, this Note explores the following regulatory responses: (1) disclosure, aimed at the retail investors; (2) product regulation, aimed at the exchange-traded option instrument; (3) conduct regulation, aimed at Robinhood (specifically both as a broker-dealer and as a trading platform); and (4) restriction of access, aimed at both retail investors and Robinhood. In exploring each of these responses, this Note seeks to explain their general operation, how they may be applied to the Robinhood options trading scenario, and their benefits and costs—specifically the potential to curb retail investor options trading without encroaching more generally on the freedom of contract and without imposing costs on private actors—namely investors and broker-dealers—as well as potential public costs faced by society.

A. Disclosure

The first and least interventionist regulatory response to curb exchange-traded option trading by retail investors is to increase mandatory disclosure requirements to ensure these investors are fully informed. Currently, Robinhood, as a broker-dealer, is required to maintain several general risk disclosures to its users, including a margin disclosure statement, day trading risk disclosure statement, product features disclosure statement, and Characteristics and Risks of Standardized Options informational document, in addition to the agreements it requires users to assent to before trading on its platform.[101] A regulatory response to increase these disclosures would appear to be consistent with the current securities law regime,[102]

101 *See* ROBINHOOD, DISCLOSURE LIBRARY, https://robinhood.com/us/en/about/legal/ [https://perma.cc/AA8W-UR85] (last visited Dec. 10, 2020).

102 *See* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 80 (2005) ("The federal securities laws generally have been considered full disclosure statutes . . . .").

where increasing mandatory disclosure requirements is used as a primary mechanism for protecting investors and maintaining efficient capital markets.[103] Likewise, all mandatory disclosure regimes place the responsibility for adequate and accurate disclosure on the shoulders of the party in possession of the most information[104]—here, the broker-dealers and the exchanges—in an attempt to reduce or eliminate information asymmetries.[105] In order to operate effectively, however, disclosure regimes make two significant assumptions about market participants: (1) that they are able to process the disclosed information effectively and efficiently; and (2) that they are able to act upon that information in a rational manner.[106] As Robinhood options trading activity during the COVID-19 pandemic highlighted, however, these underlying assumptions are by no means necessarily true and are questionable in the context of retail investors.

1. *Robinhood's Disclosures*

As a broker-dealer, Robinhood is subject to certain general risk disclosure requirements as part of its membership in FINRA.[107] In complying with these requirements, Robinhood currently discloses the risks of options trading and potential losses in numerous locations throughout its website, including its Option Risk Disclosure,[108] its Option and Instant Agree-

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[103] *See* Christine Sgarlata Chung, *The Devil You Know: A Survey Examining How Retail Investors Seek Out and Use Financial Information and Investment Advice*, 37 REV. BANKING & FIN. L. 653, 670 (2018) (discussing how retail investors, particularly brokers and investment advisers, rely on the "financial services industry" to overcome their relative lack of expertise); John C. Coffee Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 721–22 (1984) (examining the case for mandatory disclosure regimes to promoting market efficiency); *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/about/what-we-do [https://perma.cc/67HL-DALC] (last visited Nov. 19, 2020) (declaring a "Mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation").

[104] Janis Sarra, *Disclosure as a Public Policy Instrument in Global Capital* Markets, 42 TEX. INT'L L.J. 875, 876 (2007).

[105] *Id.*

[106] *See* Paredes, *supra* note 91, at 432; Bartlett, *supra* note 91, at 4 (discussing evidence of investors' lack of action with respect to derivative disclosures during the Financial Crisis).

[107] *See* FIN. INDUS. REGUL. AUTH., FINRA MANUAL: FINRA RULES: 2200. COMMUNICATIONS AND DISCLOSURES, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2200 [https://perma.cc/VRX6-HUQ7] (last visited Nov. 21, 2020); ROBINHOOD TERMS & CONDITIONS, *supra* note 17 ("Robinhood . . . is a registered broker-dealer and member of FINRA . . . .").

[108] ROBINHOOD, OPTIONS RISK DISCLOSURE [hereinafter OPTIONS RISK DISCLOSURE], https://robinhood.com/us/en/about/options/ [https://perma.cc/W6GZ-9SHF]

ment,[109] its Option Agreement,[110] as well as its Margin Disclosure Statement.[111] Additionally, prior to granting the ability to use its trading platform, Robinhood requires prospective users to attest to reading the aforementioned agreements as well as an attached disclosure document, the Characteristics and Risks of Standardized Options, produced by its central clearinghouse, The Options Clearing Corporation ("OCC"), and numerous derivatives exchanges.[112] Yet, despite these warnings, options trading for retail investors reached all-time highs during a period of extreme price volatility,[113] with trading activity for certain underlying shares approaching seemingly illogical and irrational levels,[114] suggesting that trading activity was spurred by purely entertainment purposes or that these warnings were simply ignored. This is not to say that Robinhood's disclosures are sufficient—certainly, the risks and potential losses faced by investors through exchange-traded options could be made more prominent at each stage of the trading process or perhaps, more extreme, individually attested to before each trade is executed; however, if the underlying assumptions of mandatory disclosure regimes and their efficacy are not met, then one can question whether requiring additional mandatory disclosures will achieve its intended effect and, in turn, adequately protect retail investors.

(last visited Nov. 5, 2020) ("Options transactions are often complex and may involve the potential of losing your entire investment.").

109 ROBINHOOD, OPTIONS AND INSTANT AGREEMENT, https://cdn.robinhood.com/assets/robinhood/legal/Options%20and%20Instant%20Agreement.pdf [https://perma.cc/X825-UK35] (last visited Dec. 11, 2020).

110 ROBINHOOD, OPTIONS AGREEMENT, https://cdn.robinhood.com/assets/robinhood/legal/Options%20Agreement.pdf [https://perma.cc/GSM2-RLZN] (last visited Dec. 11, 2020).

111 ROBINHOOD, ROBINHOOD FINANCIAL AND ROBINHOOD SECURITIES MARGIN DISCLOSURE STATEMENT, https://cdn.robinhood.com/assets/robinhood/legal/RHF%20and%20RHS%20Margin%20Disclosure%20Statement.pdf [https://perma.cc/5WUB-NQ9R] (last visited May 21, 2021).

112 THE OPTIONS CLEARING CORPORATION, CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS 1, 4 (1994), https://cdn.robinhood.com/assets/robinhood/legal/Characteristics%20and%20Risks%20of%20Standardized%20Options.pdf [https://perma.cc/Z2VG-QTL2] (last visited Dec. 11, 2020).

113 *See* Egan, *supra* note 2.

114 *See* Massa and Alexander, *supra* note 25 (discussing a young man's suicide after potentially misinterpreting his options trading account showing a negative balance of $700,000); Walker, *supra* note 1 (describing the "stock market's gyrations[ ] [as] often seem[ingly] wholly disconnected from the actual economy[ ] [and] more unpredictable than ever").

2. *Benefits and Costs in Practice*

As mentioned above, the effectiveness of mandatory disclosure regimes is questionable where the underlying assumptions that information is processed effectively and acted upon rationally are not met. Retail investors are particularly prone to failing both assumptions,[115] and therefore disclosure regimes aimed at them may not only be inherently ineffective but also fatally flawed. In this sense, the primary benefit of mandatory disclosure regimes—that they do not impact an investor's freedom to contract and invest—also constitutes their primary shortfall. Likewise, it has been suggested that disclosure alone is insufficient to counteract any perverse irrational human behavioral tendencies.[116]

As an initial matter, retail investors will not make more informed and rational decisions if they simply ignore disclosures.[117] As a group, retail investors are most susceptible to shrouded price equilibriums: the inadequate disclosure of a product's add-ons resulting in consumers failing to consider them in their decisions.[118] Specific to exchange-traded options, the executory contract nature of the financial instrument,[119] the risk of volatile price movements,[120] and hence significant potential losses may not only be inadequately disclosed[121] but also simply ignored.

Additionally, retail investors typically have reduced time, resources, and capacity to understand and use any disclosed financial information relative to their sophisticated counterparts, meaning even incremental disclosure increases do not necessarily lead to better decision making.[122] That is, even if an increase in mandatory disclosure would reveal the necessary information for an informed investor to act rationally, this information may nevertheless not be acted upon rationally. The inherent limitation in an investor's ability to process information, which is most extreme in the retail investor group, has

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115 Chelsea P. Ferrette, *The Myth of Investor Protection: The Dodd-Frank Act and the Office of the Investor Advocate*, 12 J. BUS. & SEC. L. 61, 69 (2011).

116 *See* JOHN R. NOFSINGER, THE PSYCHOLOGY OF INVESTING 8–17 (2d ed. 2005).

117 *See* Paul Slovic, *Psychological Study of Human Judgment: Implications for Investment Decision Making*, 27 J. FIN. 779, 779–80 (1972) (noting the difficulty of information interpretation in investment decision making, particularly in light of a human's limited processing capacity).

118 Gabaix & Laibson, *supra* note 92, at 506.

119 Awrey, *supra* note 79, at 1108.

120 *See* Awrey, *supra* note 75, at 510–11.

121 OPTIONS RISK DISCLOSURE, *supra* note 108 ("Options transactions are often complex and may involve the potential of losing your entire investment.").

122 Sarra, *supra* note 104, at 876; Ferrette, *supra* note 115, at 70.

been described as "[b]ounded rationality"—the existence of a tipping point at which providing additional information exceeds the recipient's processing ability and leads to worse decision making.[123] To add to this, complex financial disclosures are simply not intended for the common retail investor.[124] In sum, bounded rationality leads investors to selectively process certain disclosures to the exclusion of others, obtaining only an imperfect "satisfactory" understanding before an investment decision is made.[125]

B. Product Regulation

Considering the above discussion of the inherent risks of derivatives, one clear regulatory response would be to regulate the financial product itself—the exchange-traded option—to mitigate any opportunity for retail investors to trade irrationally. There are, however, significant risks associated with product regulation, including arbitrage, damage to innovation, and decreased investor choice.[126] That is, market participants are less likely to create new, potentially beneficial financial products where a mandatory product approval scheme may prohibit their entry to the market, or alternatively are more likely to trade these instruments in other jurisdictions. This in turn prevents investors trading an otherwise profitable financial instrument, restricting their choice. Additionally, given the association between product regulation and overregulation, it is unlikely that an appropriate product regulatory regime would involve a blanket ban on a financial instrument, but would instead be limited to instances only where the social costs of the financial instrument's use outweigh its benefits. Limited enforcement, however, faces significant difficulties in distinguishing between these instances or alternatively, where product regulation is imposed ex-ante, between the various purposes of trading as proxy.

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123 Paredes, *supra* note 91, at 435–36.

124 *Id.*

125 *Id.* (describing "satisficing"—the process of evaluating information at a below-optimal level, in order to cope with excessive disclosures); *see also* Russell Korobkin, *The Efficiency of Managed Care "Patient Protection" Laws: Incomplete Contracts, Bounded Rationality, and Market Failure*, 85 CORNELL L. REV. 1, 48 (1999) ("[I]ndividuals satisfice in many situations: they develop aspirations and select decision options that meet them, without regard to whether another better decision choice might theoretically exist." (internal quotation marks and citations omitted)).

126 Niamh Moloney, *The Investor Model Underlying The EU's Investor Protection Regime: Consumers or Investors?*, 13 EUR. BUS. ORG. L. REV. 169, 181 (2012).

Product regulation can be divided into ex-ante regimes and ex-post regimes, each with their own advantages and disadvantages. An ex-ante mandatory product approval regime imposes a duty for the creators or offerors of financial instruments to provide information to the relevant regulatory authority—in the Robinhood exchange-traded options context, likely the SEC—to evaluate the economic enterprise and public benefit of the new financial product before it is allowed to enter the market.[127] One notable ex-ante regime proposal is a mandatory product approval system akin to the Federal Drug Administration and pharmaceuticals[128] and the regulatory scheme for commodity futures prior to the Commodities Futures Modernization Act of 2000.[129]

Ex-post solutions, on the other hand, grant the financial regulator authority to analyze and assess the risks of the financial product after it has been traded—one pertinent example being the European Commission's MiFID II Directive.[130] MiFID II granted the European Commission and national regulators authority to prohibit or restrict certain financial instruments already purchased and sold on the market when significant investor protections are required or concerns about financial market integrity or stability arise.[131] The operation of this regime is identical to its ex-ante counterpart, only the regulatory authority is vested with the power to conduct its gatekeeping function after the financial instrument has already been traded. It goes without saying that to avoid the appearance of overregulation, any action taken must be proportional to the risks identified, the sophistication of the investors involved, and the effect on the market and the investors.[132]

1. *Benefits and Costs in Practice*

Any product regulation regime must initially decide on the application of (a) specific test(s) to determine whether a new financial instrument shall be approved or not. In the ex-ante mandatory product approval regime context, one proposal, drawing inspiration from earlier iterations, involves a three-

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127 Saule T. Omarova, *License to Deal: Mandatory Approval of Complex Financial Products*, 90 WASH. UNIV. L. REV. 63, 67–68 (2012).

128 Eric A. Posner & E. Glen Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to Twenty-First Century Financial Markets*, 107 NW. UNIV. L. REV. 1307, 1348–49 (2013).

129 Omarova, *supra* note 127, at 89.

130 Moloney, *supra* note 126, at 181–82.

131 *Id.*

132 *Id.*

part test: (1) an "economic purpose" test that requires proving commercial and social utility of the financial instrument and, in turn, disproving its potentially socially deleterious uses; (2) an "institutional capacity" test that requires the offering firm to prove it is able to monitor and manage the risks of the proposed product; and (3) a "systemic effects" test that requires proving that the financial product does not raise significant systemic risk or public policy concerns.[133] That being said, the purposes of a mandatory product approval regime can be myriad—they can prohibit financial instruments that pose excessive systemic risk,[134] curb purely speculative trading,[135] or, in the case here, curtail risk of misuse by retail investors.[136]

While in theory, an ex-ante mandatory approval regime would allow regulators to evaluate the risks and benefits of financial products before any harm is incurred, this analysis is necessarily theoretical based on financial models and quantitative data. Thus, there is an inherent limitation and potential fatal flaw in an ex-ante product analysis—that the ultimate result once the product is traded may be drastically different to the initial analysis. Additionally, concerns about the administrability of any ex-ante mandatory product approval regime exist, given the necessary delay in product release, associated costs with this delay, and the difficulty in satisfying the burden of proof such a regime imposes on dealers and offerors.[137]

Nevertheless, one significant alleged benefit of ex-ante product regulation is improved market efficiency—the initial required disclosures would increase product information available to the consumer, likely increasing consumer confidence in addition to any confidence gains from receiving regulatory approval.[138] This, too, would increase the demand for financial products.[139] This benefit has a similar analogue in ex-post

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133 Omarova, *supra* note 127, at 115–16.

134 *Id.* at 88.

135 Posner & Weyl, *supra* note 128, at 1311–12.

136 Daniel Carpenter, Justin Grimmer & Eric Lomazoff, *Approval Regulation and Endogenous Consumer Confidence: Theory and Analogies to Licensing, Safety, and Financial Regulation*, 4 REGUL. & GOVERNANCE 383, 405 n.18 (2010) (targeting "consumer financial products").

137 Omarova, *supra* note 127, at 108, 110–11.

138 *Id.* at 86.

139 *Id.*; *see also* Daniel Carpenter, Proposal for a Financial Product Approval Process with Modified File-and-Use Elements, Public Scrutiny, and Committed Experimentation (June 10, 2009) (unpublished manuscript) (available at https://dcarpenter.scholar.harvard.edu/files/dcarpenter/files/fileuse-carpenterproposal2009.pdf [https://perma.cc/989P-KSAL]) (noting that one benefit of a particular ex ante product regulation scheme was the creation of "new and better

regulation, only that the trigger occurs when the regulatory authority intervenes.

Specific to ex-post product regulation, one flaw of such a regime is that the harm to the market or the specific group of market participants has already been experienced and can only be mitigated, rather than prevented. Here, given that the sole purpose of any regulatory response aimed at the Robinhood options trading problem is to sufficiently protect retail investors from experiencing significant losses, the efficacy of an ex-post product regulation regime is questionable.

C. Conduct Regulation (Broker-Dealer)

Another potential regulatory response, conduct regulation, aims to regulate Robinhood itself, with the implicit assumption that while the ultimate root cause of the problematic Robinhood options trading lies with the investors themselves, Robinhood's option trading platform still plays a significant role. Robinhood's registration as a broker-dealer under the purview of the SEC and FINRA presents a direct avenue for an appropriate conduct-regulatory response.

1. *Broker-Dealer Requirements*

The Securities Exchange Act of 1934 defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others"[140] and a dealer as "any person engaged in the business of buying and selling securities . . . for such person's own account . . . ."[141] A broker-dealer is simply an entity that serves the purpose of both a broker and a dealer.[142] While the Securities Exchange Act of 1934 requires broker-dealers to be registered with the SEC,[143] more importantly, broker-dealers must also become members of a self-regulatory organization, such as FINRA or a national exchange, which impose their own requirements.[144] Most applicable to the situation presented by this Note are the suitability

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markets," creating more "market literate" consumers (internal emphasis omitted)).

140 Securities Exchange Act of 1934 § 3(a)(4), 15 U.S.C. § 78c(a)(4) (2018).

141 Securities Exchange Act of 1934 § 3(a)(5), 15 U.S.C. § 78c(a)(5) (2018).

142 Kenneth M. Rosen, *Financial Intermediaries as Principals and Agents*, 48 WAKE FOREST L. REV. 625, 628 (2013).

143 *See* Securities Exchange Act of 1934 § 15, 15 U.S.C. § 78o (2018); U.S. SEC. & EXCH. COMM'N, GUIDE TO BROKER-DEALER REGISTRATION (Apr. 2008), https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html [https://perma.cc/BH2B-LK2X].

144 Rosen, *supra* note 142, at 635–36.

and "know-your-customer" rules of FINRA, of which Robinhood is a member.[145]

Under FINRA's suitability rules, a broker-dealer must have "reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on . . . the customer's investment profile."[146] A customer's investment profile includes their "age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, [and] risk tolerance."[147] Importantly, however, broker-dealers are only required to comply with these suitability requirements when they recommend a transaction or strategy to a customer—suitability is not a blanket fiduciary duty.[148]

Exactly what constitutes a "recommendation" under the FINRA rules is unclear—it is not explicitly defined—although it has been suggested that an objective inquiry is used to determine whether any communication would reasonably be viewed as a "call to action" and could influence the customer to enter into a particular transaction or trading strategy.[149] In application, generalized statements about a security do not constitute recommendations nor the distribution of marketing materials; instead, a broker-dealer must do something greater than executing a customer's orders and trades.[150]

Where these suitability requirements may be violated, it is also important to note the impact that a disclaimer or waiver may have. Investors are typically required to sign disclaimers

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145 ROBINHOOD TERMS & CONDITIONS, *supra* note 17 ("Robinhood . . . is a registered broker-dealer and member of FINRA . . . ."); *see* FIN. INDUS. REGUL. AUTH., *infra* note 149.

146 FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 2111, https://www.finra.org/rules-guidance/rulebooks/finra-rules/2111 [https://perma.cc/2X5R-YCXU] (last visited Apr. 16, 2021).

147 *Id.*

148 Chung, *supra* note 103, at 671.

149 FIN. INDUS. REGUL. AUTH., REGULATORY NOTICE 11-02, KNOW YOUR CUSTOMER AND SUITABILITY 2 (Oct. 7, 2011), https://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf [https://perma.cc/4UUM-NMHX]; Lynn Bai, *Broker-Dealers, Institutional Investors, and Fiduciary Duty: Much Ado About Nothing?*, 5 WM. & MARY BUS. L. REV. 55, 77 (2014).

150 *See* Bai, *supra* note 149, at 57 (distinguishing between advisory and broker-dealer services); *see also* Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992) (noting that fiduciary duties can be imposed on an ad hoc basis where "a person solicits another to trust him in matters in which he represents himself to be expert as well as trustworthy and the other is not expert and accepts the offer and reposes complete trust in him, a fiduciary relation is established"); United States v. Hart, 273 F.3d 363, 376 (3d Cir. 2001) (providing a three-part test to determine whether a defendant occupies a "position of trust").

attesting to their sophistication, self-direction, and/or non-reliance,[151] designed to insulate broker-dealers from liability. Section 14 of the Securities Exchange Act of 1933 and Section 29(a) of the Securities Exchange Act of 1934 both invalidate any contractual provision purportedly allowing a broker-dealer to waive compliance with the securities statutes.[152] That is, despite any waiver, a broker-dealer must still comply with any suitability and know-your-customer requirements. Courts, however, have not held these disclaimers to be invalid per se, but analyze each on the individual facts and circumstances, focusing on "the degree of detail in the broker-dealers' explicit representations and warranties, the specificity of disclaimers, the length of negotiations, and the extent of diligence done by the client-investor."[153] The validity of these disclaimers in contracts of adhesion signed by retail customers appears unexplored.

Additionally, under FINRA's "know[-]your[-]customer" rules, broker-dealers must "use reasonable diligence . . . to know (and retain) the essential facts concerning every customer . . . ."[154] FINRA does not specify what constitutes an "essential fact[ ]" and leaves retention of these facts up to the individual broker-dealer's judgment.[155] The know-your-customer rules further do not impose any affirmative duty on the broker-dealer to investigate the customer's investment profile,

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151 ROBINHOOD TERMS & CONDITIONS, *supra* note 17 ("You are solely responsible for evaluating the merits and risks associated with the use of any Content provided through the Service before making any decisions based on such Content."); WEBULL, APEX CUSTOMER ACCOUNT AGREEMENT, https://pic.webull.com/PDFs/CUSTOMER%20ACCOUNT%20AGREEMENT-WITH%20APEX.pdf [https://perma.cc/5YKF-R8KL] (last visited Nov 19, 2020) ("[WeBull] will have no responsibility for trades made in the Customer's accounts."); TD AMERITRADE, CLIENT AGREEMENT, https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD182.pdf [https://perma.cc/PDH6-SWPZ] (last visited Nov 19, 2020) ("[The customer is] responsible for all purchase and sell orders, decisions to continue with an investment strategy or to hold an investment, and instructions placed in [their] account.").

152 Securities Exchange Act of 1933 § 14, 15 U.S.C.A. § 77n (2018); Securities Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc(a) (2018).

153 Bai, *supra* note 149, at 92; *see also Burdett*, 957 F.2d at 1381 (stating that an alleged fiduciary could have protected himself through explicit representations); *Hart*, 273 F.3d at 376 (providing a three-part test to determine whether a defendant occupies a "position of trust").

154 FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 2090, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858 [https://perma.cc/J9CJ-Y3YQ] (last visited Apr. 16, 2021).

155 *See* FIN. INDUS. REGUL. AUTH., REGULATORY NOTICE 11-02, KNOW YOUR CUSTOMER AND SUITABILITY 2 (Oct. 7, 2011), https://www.finra.org/sites/default/files/NoticeDocument/p122778.pdf [https://perma.cc/4UUM-NMHX].

only requiring the duty to act reasonably on the information provided.[156] While the creation of a fiduciary duty has been suggested, or at the very least an affirmative duty to monitor customer decisions, there is considerable authority opposing such creation.[157] Most notably, the U.S. Treasury's Financial Regulatory Reform Whitepaper[158] proposed establishing a uniform, federally-defined fiduciary duty on broker-dealers in the wake of the global financial crisis but was ultimately rejected[159]—the SEC instead opting for an "act[ing] in . . . best interest[s]" standard that both overlaps with FINRA's rules and has consequently been criticized for lacking teeth.[160]

2. *Robinhood as a Broker-Dealer*

Unsurprisingly, Robinhood explicitly disclaims making any "recommendation" to its customers, describing them instead as "self-directed."[161] By doing so, Robinhood avoids compliance with FINRA's suitability requirements, which, if otherwise enforced, would likely be violated. Robinhood's customer base, a significant portion of which not only are completely new to the stock market but also possess modest net wealth at the incep-

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156 THOMAS LEE HAZEN, BROKER-DEALER REGULATION IN A NUTSHELL 203 (3rd ed. 2017).

157 *Id.* at 205–06; *see* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 537 (2d Cir. 1999) (holding that a fiduciary did not have to disclose a significant markup to his clients). *But see* Jordan v. UBS AG, 782 N.Y.S.2d 722, 723 (N.Y. App. Div. 1st Dep't 2004) (stating that "[a]bsent agreement to the contrary, . . . a broker does not owe fiduciary duties to a purchaser of securities"); Associated Randall Bank v. Griffin, Kubik, Stephens & Thompson, Inc., 3 F.3d 208, 212 (7th Cir. 1993) (stating that a "broker-dealer in Wisconsin is not a fiduciary with respect to accounts over which the customer has the final say, and in the absence of unusual circumstances owes its customer only a duty of ordinary care"); SFM Holdings, Ltd. v. Banc of Am. Sec., LLC, 600 F.3d 1334, 1338–39 (11th Cir. 2010) (stating that "[l]ike prime brokers, clearing brokers ordinarily owe no fiduciary duty to the customers of introducing brokers").

158 *See generally*, U.S. DEP'T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009), https://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf [https://perma.cc/VD3V-74WA].

159 *See* Matthew P. Allen, *A Lesson from History, Roosevelt to Obama—The Evolution of Broker-Dealer Regulation: From Self-Regulation, Arbitration, and Suitability to Federal Regulation, Litigation, and Fiduciary Duty*, 5 ENTREPRENEURIAL BUS. L.J. 1, 8 (2010).

160 Tara Siegel Bernard, *S.E.C. Adopts New Broker Rules That Consumer Advocates Say Are Toothless*, N.Y. TIMES (June 5, 2019), https://www.nytimes.com/2019/06/05/your-money/sec-investment-brokers-fiduciary-duty.html [https://perma.cc/M863-RE7H].

161 *See supra* note 17; ROBINHOOD, https://robinhood.com/us/en/ [https://perma.cc/RSM7-8377] (last visited Oct. 29, 2020) ("Securities trading is offered to *self-directed customers* by Robinhood Financial." (emphasis added))

tion of their professional careers,[162] likely fail to fully comprehend the risks of trading exchange-traded options, let alone possess the financial means to engage in extensive options trading, given the significant price volatility of these options.[163] While it may be clear that Robinhood is not subject to suitability requirements as a broker-dealer as the law currently stands, this begs the question whether FINRA's suitability requirements should be expanded.

3. *Benefits and Costs of Expanding FINRA's Suitability Rules*

The plain text of FINRA's suitability rules reveals the inherent category capture problems for many savvy broker-dealers like Robinhood, who claim not to make recommendations to their customers and further include disclaimers or waivers in their customer agreements. While an initial response may be to expand the meaning of "recommending" a transaction or to create an affirmative duty to monitor investment decisions, any changes would apply to all broker-dealers that are members of the self-regulatory organization—the FINRA rules apply to broker-dealers offering all "securities,"[164] not just derivatives, meaning any blanket amendment would also affect broker-dealers for ordinary shares. Further, while such a change may result in more prudent retail investor investment choices, broker-dealers would be charged with monitoring and gatekeeping duties for their customers. Not only would this defy previous authority,[165] it would impose significant costs on broker-dealers, which would then likely be passed onto the end-user. Amending FINRA rules for broker-dealers might not only represent an overreaction to the Robinhood options trading problem but may significantly restrict access to certain financial

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162 Alexander Osipovich and Caitlin McCabe, *Coronavirus Turmoil, Free Trades Draw Newbies into Stock Market*, WALL ST. J. (Apr. 29, 2020), https://www.wsj.com/articles/coronavirus-turmoil-free-trades-draw-newbies-into-stock-market-11588158001 [https://perma.cc/A6Z9-9ATF]; *see also,* Walker, *supra* note 1 (noting that it was easier for Robinhood to attract customers new to the stock market, rather than poaching customers from its competitors).

163 Charles T. Terry, *Option Pricing Theory and the Economic Incentive Analysis of Nonrecourse Acquisition Liabilities*, 12 AM. J. TAX POL'Y 273, 336–37 (1995).

164 Section 15(b)(8) of the Securities Exchange Act of 1934 requires broker-dealers effecting transactions in securities or inducing or attempting to induce the purchase or sale of any security to become a member of a securities association registered. Securities Exchange Act of 1934 § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2018).

165 *See* HAZEN *supra* note 156, at 205–206.

markets for retail investors and infringe on their otherwise general freedom to make their own investment decisions.

One possible amendment to this regulatory response, however, presents a more manageable approach in limiting the imposition of costs on private actors—a two-tier suitability requirement for derivatives trading.[166] Where the relevant client is sophisticated or adequately capitalized, the proposed two-tier suitability requirement's safe harbor provision applies,[167] and the broker-dealer is not subject to any significant affirmative duties. On the other hand, for retail investors that do not fall under the safe harbor, these investors must be affirmatively deemed by the broker-dealer to be suitable for derivatives trading[168]—a designation based on possession of the requisite understanding of the risks and sufficient capitalization.

D. Conduct Regulation (Trading Platform)

Given the potential inefficacy of regulating Robinhood's conduct via broker-dealer regulation, another potential regulatory response that also constitutes conduct regulation—the regulation of Robinhood as a trading platform. Similar to the underlying principles of broker-dealer regulation, trading platform regulation would seek to establish affirmative duties on Robinhood with respect to its novice customer base. Trading platform regulation, however, may greater be able to target Robinhood's option-trading activity more specifically without overregulating the entire industry, largely due to the fact that Robinhood does not sell shares and options directly to its customers but to high volume trading firms[169] and, further, due to its uniquely gamified user interface.[170] The combination of payment for order flow may be a relatively recent trend in light of the broker-dealer industry's no-fee movement, but its combination with a gamified user platform and inadequate disclosure make Robinhood a particular target for regulatory response. It

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166 Geoffrey B. Goldman, Note, *Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed"?*, 95 COLUM. L. REV. 1112, 1115 (1995).

167 *Id.*

168 *Id.*

169 *See* Maggie Fitzgerald, *SEC Charges Robinhood with Misleading Customers About How It Makes Money*, CNBC (Dec. 17, 2020), https://www.cnbc.com/2020/12/17/sec-charges-robinhood-with-misleading-customers-about-how-it-makes-money.html [https://perma.cc/5KZW-GQHC].

170 James Chen, *Robinhood Pays Settlement, but Gamification Remains a Concern*, INVESTOPEDIA (Dec. 21, 2020), https://www.investopedia.com/robinhood-pays-settlement-but-gamification-remains-a-concern-5093195 [https://perma.cc/E4JW-CWDR].

is important to highlight that the Securities and Exchange Commission's recent fine of Robinhood for misleading customers as to how they profited from their trades and exactly how a customer's trades were executed concerned Robinhood's activity prior to 2018 and is somewhat different from the subject of this Note.[171]

1. *Establishing Affirmative Duties Towards Investors*

Regulating Robinhood as a trading platform requires recognizing that the transactions a Robinhood client enters into are somewhat different from an ordinary broker's client. Ordinarily, a broker is thought to execute transactions for their clients directly on a securities exchange.[172] However, when a broker instead routes the right to execute those trades to another trading firm in exchange for a small fee, the exact role of the broker is less clear, particularly in light of their general "duty of best execution."[173] To be sure, this behavior is not exclusive to Robinhood; its primary commission-free trading competitors, TD Ameritrade and Charles Schwab, also profit from the same type of activity, commonly known as "payment for order flow."[174] Rather than functioning as an ordinary broker-dealer, it would appear that the activity of these trading platforms resembles something closer to that of a counterparty, particularly in the context of exchange-traded options, where Robinhood made $111 million in the second quarter of 2020.[175]

In turn, a question arises whether Robinhood exchange-traded options can truly be classified as exchange-traded, given there is at least one degree of separation between the customer's trade orders and the final order being executed on the securities exchange. Pursued to the extreme, such trades could be considered akin to being over-the-counter (OTC), where a completely separate legal regime governing duties of

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171 *See* Fitzgerald, *supra* note 169.

172 *See* U.S. SEC. & EXCH. COMM'N, *supra* note 143 ("[A] person who executes transactions for others on a securities exchange clearly is a broker.").

173 Andrew Keshner, *Why Robinhood's $65 Million Fine Is a Cautionary Tale for Retail Investors: 'You're Saving a Penny to Lose a Nickel'*, MARKETWATCH (Dec. 26, 2020), https://www.marketwatch.com/story/youre-saving-a-penny-to-lose-a-nickel-why-robinhoods-65m-fine-is-a-cautionary-tale-for-retail-investors-2020-12-17 [https://perma.cc/Y4FU-QMSU].

174 *See* Fitzgerald, *supra* note 169.

175 Jeff Kauflin, *Robinhood Doubles Its Second-Quarter Trading Revenue, Reaching $180 Million*, FORBES (Aug. 3, 2020), https://www.forbes.com/sites/jeffkauflin/2020/08/03/robinhood-doubles-its-second-quarter-trading-revenue-reaching-180-million/?sh=E6c499b768cd [https://perma.cc/J8RW-PNDH].

counterparties, collateral, and clearinghouse use exists. At its core, payment for order flow changes the legal and financial structure of a customer's order and how it should be regulated accordingly.

2. *Benefits and Costs in Practice*

The regulation of trading platforms that sell their order flows to high volume trading firms could be viewed as an appropriate regulatory response to the somewhat misleading broker-dealer industry trend towards commission-free trading. That is, while trades are labelled as "commission-free," costs are shifted from upfront commissions to incremental takings from a client's profits, rather than completely eliminated.[176] Regulating this behavior may benefit the retail investor in the short-term by decreasing their cost of trading securities and options—however, whether trading platforms would be able to maintain profits from any such elimination in fees is yet to be seen and likely doubtful. In turn, while in theory, a complete elimination of costs or fees may appear to be ideal, a more realistic option may be to require greater transparency as to the true costs of using trading platforms such as Robinhood.

In fact, the Securities and Exchange Commission recently fined Robinhood for exactly that—misleading customers as to how they profited from their trades and exactly how a customer's trades were executed—but seemingly spared Robinhood's competitors.[177] The same underlying difficulty of increasing transparency through disclosure with respect to Robinhood's activity as a trading platform, however, arises just as it does when attempting to inform retail investors of the inherent risks of options-trading and the role of Robinhood as a broker-dealer, as discussed in subpart IV.A. That is, disclosure regimes, when aimed at retail investors, seemingly fail to satisfy two significant necessary assumptions: (1) that the recipient is able to process the disclosed information effectively and efficiently; and (2) that the recipient is able to act upon that information in a rational manner.[178] As Robinhood options-trading activity during the COVID-19 pandemic highlighted, however, these underlying assumptions are questionable in the context of retail investors. A complete ban on payment of order flow would likely result in fewer opportunities for retail investors to trade securities and options, ultimately reducing their

176 Chen, *supra* note 170.
177 *See* Fitzgerald, *supra* note 169.
178 *See* Paredes, *supra* note 91, at 432; Bartlett, *supra* note 91, at 4.

access to financial markets. On the other hand, a disclosure regime that presents the true costs of order flow to retail investors' profits may be wholly ineffective and provide no meaningful solution to consumers being misled by what is described as "commission-free" trading.[179]

The Securities and Exchange Commission's recent fine also could be considered problematic in that it represents a settlement, rather than an admission of any wrongdoing, potentially driven by its upcoming initial public offering on the New York Stock Exchange.[180] This ultimately continues to leave the door open as to whether such conduct can be replicated or continue in the marketplace and further result in significant retail investor losses. To be sure, the fine was based not on Robinhood's current conduct but on conduct based in 2015 to 2018 and the inadequate disclosures and customer communication,[181] begging the question as to what Robinhood has rectified in the past two years that corrects any wrongdoing, if any.

E. Restriction of Access

The final regulatory response explored by this Note is the restriction of access to a specific financial product by a class of investors. Applied to the scenario at hand, such a response would directly target the financial instrument—the exchange-traded option—but limit the impact to retail investors, recognizing them as the root cause of the problematic Robinhood options-trading activity during COVID-19. Under the current securities law regime, restricting access to exchange-traded options by retail investors appears to be simple—by allowing only market participants that fit the existing "sophisticated investor" and "accredited investor" categories to trade exchange-traded options, retail investors would be functionally restricted from the market.[182]

1. *Benefits and Costs in Practice*

While the exact definitional scope of a restriction-of-access regulatory response may vary depending on the selected proxy,

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179 Fitzgerald, *supra* note 169.

180 *See* Chen, *supra* note 170.

181 Fitzgerald, *supra* note 169.

182 Cary Martin, *Private Investment Companies in the Wake of the Financial Crisis: Rethinking the Effectiveness of the Sophisticated Investor Exemption*, 37 DEL. J. CORP. L. 49, 51–52, 51 n.2–3 (2012).

the underlying benefits and costs of this regulation will nevertheless have similar results.

The single most significant benefit of a restriction-of-access regime is the complete prevention of losses by the restricted group of market participants. By preventing access to exchange-traded options, retail investors are unable to trade in the financial derivative and, in turn, are prevented from experiencing the significant losses witnessed during the COVID-19 pandemic. An implicit assumption of this response and, in turn, why it may be appropriate, is that regulation can only sufficiently protect retail investors from significant losses when access is completely prevented, particularly given the purely speculative trading and gambling purposes that may be undeterred by other regulatory responses. When the United Kingdom's Financial Conduct Authority (FCA) adopted restrictions on contract-for-difference-like options for retail investors in 2019, they specifically noted that restricting access would help prevent significant losses for retail investors, who were primarily trading for purely speculative purposes.[183] Likewise, with respect to the FCA's complete ban on the sale of crypto asset products, it was also concluded similar benefits would be recognized regarding the prevention of significant retail investor losses.[184] As a potential direct analogue to the problematic Robinhood options-trading activity, they stated that crypto currency derivatives did not serve any legitimate need for retail investors, recognizing only extremely rare circumstances where the financial instrument was used for hedging purposes.[185]

On the other hand, the two notable potential costs of such a regime revolve around its inherent category capture problems as well as the significant encroachment on an investor's general freedom of contract, resulting in lost potential retail investor *profits* and lost business profits for broker-dealers and exchanges. Firstly, any restriction of access regime is inherently limited by the accuracy of the proxy used. That is, while this Note discusses "retail investors" generally as the target, exactly how a retail investor is defined in legislation may limit this response's effectiveness. The SEC's categorical definition of "accredited investor" is based on the individual's wealth and

183 FIN. CONDUCT AUTH. (UK), PS20/10 PROHIBITING THE SALE TO RETAIL CLIENTS OF INVESTMENT PRODUCTS THAT REFERENCE CRYPTOASSETS 15 (2020) https://www.fca.org.uk/news/press-releases/fca-bans-sale-crypto-derivatives-retail-consumers [https://perma.cc/3RW9-6B94].

184 *Id.* at 25.

185 *Id.* at 13.

income[186] on the presumption that these investors possess sufficient resources to protect themselves.[187] An individual's wealth, however, does not necessarily correlate to their investment expertise.[188] A sophisticated investor, by the SEC's definition, may be no more "sophisticated" than the retail investor, but rather simply wealthier.[189] In the context of Robinhood options trading, while sophisticated investors may be able to trade more frequently yet remain within their financial means, they may nevertheless fail to fundamentally comprehend the financial product and, in turn, suffer the same significant losses. Secondly, restriction of access not only prevents retail investors from otherwise freely trading in the financial product but also prevents any potential profits for investors, broker-dealers, and exchanges. It is important to note here, however, that where the total savings of retail investor losses outweighs the total loss in profits, as it did when the FCA restricted retail consumers from trading contract-for-difference-like options,[190] society, economically as a whole, may in fact benefit from this regulatory response.

CONCLUSION

The above high-level exploration of potential regulatory responses reveals both distinct and similar benefits and costs between each approach. Setting aside the apparent ineffectiveness of increasing mandatory disclosures—which may be inherently ineffective for a retail investor audience—product regulation, conduct regulation (both via broker-dealer regulation and trading platform duties), and restriction of access all present direct avenues to address different levels of the Robinhood options-trading problem. The inherent limitation of product regulation rests in its inability to effectively discern between the different purposes and investors with only an ex-ante purview of the instrument itself, while restriction of access

186 *See, e.g.*, U.S. Sec. and Exch. Comm'n, *Accredited Investors—Updated Investor Bulletin*, INVESTOR.GOV (Apr. 14, 2021), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins/updated-3 [https://perma.cc/27T6-3C7K] (listing income and net worth requirements of accredited investors).

187 Martin, *supra* note 182, at 51–52.

188 So-Yeon Lee, *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 991 (2012).

189 U.S. Sec. and Exch. Comm'n, *supra* note 186.

190 FIN. CONDUCT AUTH. (UK), CP18/38 RESTRICTING CONTRACT FOR DIFFERENCE PRODUCTS SOLD TO RETAIL CLIENTS AND A DISCUSSION OF OTHER RETAIL DERIVATIVE PRODUCTS 40 (2019) https://www.fca.org.uk/publication/consultation/cp18-38.pdf [https://perma.cc/JC3U-4KFK].

may be conceived as an overreaction to a problem that appears to be limited to one specific trading platform. In turn, viewing Robinhood itself as the most direct means of attempting to resolve the options-trading problem, regulating Robinhood as a trading platform and establishing affirmative duties to protect its retail customer base appears to be a more appropriate solution. In doing so, retail investors' trading behavior using Robinhood can be distinguished from their behavior using its competitors, and the significant losses and over-trading witnessed during the pandemic may appropriately be curbed.