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Democracy Dies in Darkness

Robinhood and Citadel's relationship comes into focus as Washington vows to examine stock-market moves

Trading firms at center of Reddit-fueled stock surges have worked closely to share users' market data, build political influence

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Robinhood, the online trading app heralded by some as a democratizing force to empower small investors, has spent the past few years nurturing a close relationship with one of Wall Street's biggest players and building ties with some of the most powerful institutions in Washington.

The Silicon Valley-based trading platform makes a large amount of revenue from Citadel Securities, a Chicago-based financial-services giant. Robinhood's regulatory filings show the company charges large investment firms called "market makers" fees to access real-time information about which stocks its users are buying and selling, a practice some regulators and industry watchers have seen as a potential conflict of interest.

Robinhood routes more than half of its customer orders to Citadel, by far its largest market-making partner by volume, Robinhood disclosures show. The app also works with Virtu, G1 Execution Services, Wolverine and Two Sigma.

Robinhood's relationships with these investment firms is likely to face new scrutiny after the online broker took the extraordinary step Thursday of limiting trading of certain stocks that were propelled to meteoric heights by conversations on Reddit message boards. After the trading halt, Reddit users accused Citadel and its billionaire founder, Ken Griffin, of pressuring Robinhood to limit trading of certain stocks, a move that may have prevented further losses for the short-sellers that lost billions betting against GameStop.

On Twitter and the Reddit forum Wallstreetbets, retail investors speculated that Robinhood had caved to pressure from its powerful business partner. Because the company does not charge its users any fees, a key part of Robinhood's business model relies on Citadel and similar companies.

In a blog post Thursday afternoon, Robinhood strongly denied its move was influenced by the large investment firms it works with to execute trades. "This was a risk-management decision, and was not made on the direction of the market makers we route to," the company wrote. A spokeswoman for Robinhood declined to comment on the company's relationships with market makers.

Josh Zeitz, a spokesman for Citadel Securities, said in a statement that the company "has not instructed or otherwise caused any brokerage firm to stop, suspend, or limit trading or otherwise refuse to do business."

Citadel LLC, a separate hedge fund also founded by Griffin, recently helped bail out Melvin Capital, a fund that sank 30 percent in a few weeks after shorting GameStop.

The events triggered a swift response from a wide range of lawmakers, from Rep. Alexandria Ocasio-Cortez (D-N.Y.) to Sen. Ted Cruz (R-Tex.), who said they supported an investigation of Robinhood's decision to block trading in GameStop. Rep. Maxine Waters (D-Calif.) announced that the House Financial Services Committee would hold a hearing to examine how the market "has been manipulated by hedge funds and their financial partners to benefit themselves while others pay the price."

Lauren Hitt, a spokeswoman for Ocasio-Cortez, told The Washington Post that the congresswoman believes "Citadel's role needs to be examined."

On Friday, the Securities and Exchange Commission said the agency was "closely monitoring" the stock-market volatility, which it said "has the potential to expose investors to rapid and severe losses and undermine market confidence."

Robinhood announced it would allow "limited buys" of GameStop and other heavily shorted stocks to resume Friday, sending shares of GameStop soaring more than 70 percent.

Congress plans to examine Citadel's agreement to obtain trading data from Robinhood in exchange for millions of dollars. These types of arrangements, called payments for "order flows," have become more common in recent years and more lucrative during the pandemic trading boom of the past year. They have also drawn growing scrutiny from federal regulators who have raised concerns that they can hurt average investors.

Because of the GameStop frenzy, "the regulators have a chance to really examine what's going on and get access to information about what these relationships really are like," said Robert Weissman, president of Public Citizen, a nonprofit consumer advocacy organization.

Robinhood and other brokerages cannot execute trades directly, so they usually work with market-making firms. Robinhood is required by law to work with market makers that can give their users the best market prices for a given trade. When Robinhood directs a transaction to one of these third parties, the market maker learns which security is being bought or sold before the trade happens.

Citadel and other market makers pay Robinhood a small fee for this privilege, which gives the market-making firms information about retail trading patterns. Citadel said it uses this information to improve its trading algorithms. Market makers also take a small profit on the "spread," or difference in price between what a Robinhood user pays and the price at which the security is being sold in the market.

Robinhood generated $271 million from all order-flow payments in the first half of 2020, according to regulatory filings. Because it is a closely held company, Robinhood does not disclose how much of its total revenue comes from order-flow payments. A spokeswoman for Robinhood declined to comment on the company's business model.

TD Ameritrade, another major online brokerage, generated about $560 million from those payments over the first half of 2020, but because the company makes money from other services, that represented only about one-fifth of its sales over that period.

Critics of these arrangements say they amount to a hidden tax on unsuspecting mom-and-pop investors. Democrat Carl Levin, a former senator representing Michigan, recently argued in an editorial for the Financial Times that the Biden administration should abolish the practice of order-flow payments.

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Last month, Robinhood paid $65 million to settle a charge by the SEC related to its order-flow agreements. The federal agency found Robinhood had misled its users by failing to disclose the payments it received from investment firms and failing to find investment partners that offered the most competitive rates for executing trades.

At the time, Robinhood said in a statement that it has been fully transparent in its communications with customers about current revenue streams and that the settlement related to "historical practices that do not reflect Robinhood today."

The new regulatory scrutiny around GameStop trading will test the political influence of two companies that have invested in building connections in Washington. Last year, Robinhood bulked up its regulatory staff, spent $275,000 lobbying the federal government and hired lobbyists with ties to a Wall Street regulator and congressional oversight committees, according to disclosure filings and an analysis by the Center for Responsive Politics.

Robinhood's chief legal officer is Dan Gallagher, a Republican appointee to the SEC who served as a commissioner there from 2011 to 2015 and was known for his persistent criticism of the Dodd-Frank Act, financial regulation passed after the 2008 crisis. Beth Zorc, a lawyer who worked at the Department of Housing and Urban Development in the Trump administration after roles as a senior aide to the Senate Banking Committee and the House Financial Services Committee, joined Robinhood late last year to help oversee its federal lobbying efforts.

"There's a lot of hard competition, but the financial sector is one of the worst, most egregious areas for revolving door between government and regulated industry," Weissman said.

Citadel spent $520,000 on lobbying in 2020 and counted a former Treasury Department employee and a former tax aide on Capitol Hill among its lobbyists.

Citadel also paid Janet Yellen, President Biden's newly installed treasury secretary, between $710,000 and $760,000 in speaking fees in 2019 and 2020, according to her financial disclosure forms. When asked in a news briefing Thursday about the payments and whether Yellen would recuse herself from advising Biden on issues related to Robinhood, White House press secretary Jen Psaki said it is normal for experts such as Yellen to be paid for advice while not actively serving in a government role.

"The secretary of treasury is one of the world-renowned experts on markets, on the economy," Psaki said. "It shouldn't be a surprise to anyone she was paid to give her perspective and advice."

Citadel declined to comment on its lobbying or payments to Yellen.

Yellen said in her ethics agreement upon her nomination that she would seek written authorization before she participated "personally and substantially" in any matter involving Citadel or other financial firms she received speaking fees from.

Asked whether Yellen would seek that authorization, Treasury Department spokesman Calvin Mitchell did not respond directly. "Secretary Yellen of course will abide by her ethics pledge in all instances," Mitchell said.