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Retail Investors: Why Online Investing Platforms Need More Regulation and Oversight

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RETAIL INVESTORS: WHY ONLINE INVESTING PLATFORMS NEED MORE REGULATION AND OVERSIGHT

ABSTRACT

Retail trading, in the age of the COVID-19 pandemic, has reached impressive and consequential levels, mostly due to the rise in popularity of online investing platforms. These platforms greatly increase the accessibility of the stock market and the ability to create wealth for young investors. However, this recent surge in activity has dramatically affected the stock market in various ways and led to many negative outcomes for retail investors themselves. This Note uses several examples, surrounding the use of the platform Robinhood, to argue for action by the SEC and FINRA to implement additional protections for retail investors who utilize such platforms. Specifically, this Note calls for FINRA to modify its existing rules regarding account opening and approval and to provide a more detailed account approval process. This Note also argues for required education for retail investors looking to access certain complex and high-risk trading products.

INTRODUCTION

For almost two years, online investing platforms such as Robinhood, Charles Schwab, and E-Trade have seen a dramatic increase in new accounts which many attribute to the COVID-19 pandemic and the fact that many young investors were stuck at home without many other forms of entertainment.[1] In particular, Robinhood saw a 151% increase in its number of funded accounts from March 2020 (7.2 million accounts) to July 2021 (18 million accounts).[2] As the market crashed in early 2020, millennials and other retail investors jumped at the opportunity to invest while prices were down, sending shares of bankrupt and struggling companies soaring.[3] With this surge in activity, Robinhood, which was founded with the goal of making the stock market and investing more accessible to everyone,[4] has faced the scrutiny of lawmakers, a wrongful-death lawsuit after the suicide of one of its young users, a record-breaking $70 million fine from the Financial

1. *See* Mark Reeth, *The Future of Retail Investing Is Now*, U.S. NEWS (June 17, 2020), https://money.usnews.com/investing/stock-market-news/articles/the-future-of-retail-investing-is-now; Joey Klender, *How Tesla (TSLA) Took Advantage of the Retail Investing Boom*, TESLARATI (Aug. 31, 2020), https://www.teslarati.com/tesla-tsla-advantage-retail-investing-boom/.

2. *See* Maggie Fitzgerald, *Robinhood Has 18 Million Accounts with $80 Billion in Assets After Rapid Growth, IPO Filing Shows*, CNBC (July 2, 2021), https://www.cnbc.com/2021/07/01/robinhood-has-18-million-accounts-managing-80-billion-after-rapid-one-year-growth-ipo-filing-shows.html.

3. *See* Reeth, *supra* note 1; Alexander Jones, *GameStop: What Happened, and What It Means*, INT'L BANKER (Mar. 29, 2021), https://internationalbanker.com/brokerage/gamestop-what-happened-and-what-it-means/.

4. *See Careers*, ROBINHOOD, https://careers.robinhood.com (last visited Oct. 2, 2020).

Industry Regulatory Authority (FINRA), and dozens of class action lawsuits from its own customers.[5]

While the increased accessibility of the stock market provides easier access to wealth creation for retail investors and benefits to the companies they are investing in, dangers can arise without adequate protections in place for those retail investors with limited relevant knowledge and experience. For example, the suicide of the twenty-year-old Robinhood user occurred after he executed a complex options trade on margin and the trading app reported a negative $730,000 balance in his account.[6] He wrote in his suicide note that he had "no idea" what he was doing.[7] Devastatingly, this balance was likely a notification of only a portion of the total trade, and it did not reflect his actual liability.[8]

This Note will use the example of Robinhood to argue that in order to safely promote the accessibility to the stock market that such broker-dealers are providing, the Securities and Exchange Commission (SEC) and FINRA need to provide more explicit guidelines surrounding the eligibility requirements which allow retail investors to access certain complex and high-risk trading products. The SEC and FINRA should also consider the imposition of educational requirements for less sophisticated investors seeking to access these products.

Part I will discuss the history of retail investing platforms and the benefits they provide to retail investors and the stock market overall. Part II will focus on the pros and cons of several complex and high-risk trading products that retail investors currently have easy access to with little to no supervision. Part III will outline the current applicable FINRA rules regarding account approval and opening, and the concerns they raise. Finally, Part IV will highlight consumer protections that have been established in the student loan and mortgage industries. These examples will be used to suggest modifications to FINRA guidelines in order to facilitate additional protections for retail investors. Specifically, this Note will argue for a specific account approval process provided by FINRA, as well as required education for retail investors looking to access certain trading products.

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5. *See* Christy Bieber, *New SEC Investigations Show Robinhood May Be an Investing Villain, Not a Hero*, MOTLEY FOOL (Sept. 1, 2020), https://www.fool.com/investing/2020/09/01/new-sec-investigations-robinhood-investing-villain/; *see also* Sheelah Kolhatkar, *Robinhood's Big Gamble*, NEW YORKER (May 10, 2021), https://www.newyorker.com/magazine/2021/05/17/robinhoods-big-gamble; Brittney Myers, *What's Going on With Robinhood? Here's What You Need to Know*, THE ASCENT (Aug. 6, 2021), https://www.fool.com/the-ascent/buying-stocks/articles/whats-going-on-with-robinhood-heres-what-you-need-to-know/.

6. *See* Avi Salzman, *Congressman Calls Robinhood 'Unethical' as Trading Start-Up Vows to Improve*, BARRON'S (Aug. 14, 2020), https://www.barrons.com/articles/robinhood-unethical-options-business-model-market-makers-suicide-51597439667.

7. *Id.*

8. *Id.*

I: THE HISTORY AND BENEFITS OF RETAIL INVESTING PLATFORMS

In the mid-1990s, as the Internet started growing in use and recognition, E-Trade became the first online brokerage firm.[9] Soon after this, its competitors also entered the online brokerage market and began to offer their services to investors at greatly reduced costs.[10] For almost two decades, these companies competed with each other as the number of Americans owning stock started to increase due to these lower costs and the ease of access to the stock market through the Internet.[11] Then, in 2013, Robinhood was founded, offering commission-free trading, and it quickly grew from one million users in its first year[12] to almost eighteen million in 2021.[13] In 2019, responding to this increased competition, all broker-dealers cut their commissions to $0 and began to consolidate with several mergers and acquisitions.[14] At the same time, advances in technology have led to websites and smart phone apps that are more convenient and user-friendly.[15] Further, brokers have recently started offering fractional shares to allow investors with less funds to own a portion of the largest players in the market.[16]

As the monetary cost of investing decreased and brokers lowered the barriers to entry through their platforms,[17] retail investors eventually accounted for 10-15% of the market's trades in 2019.[18] Then, in the first quarter of 2020, the S&P 500 fell more than 20% as the market crashed due to the COVID-19 pandemic, and retail investors rushed into the market, eager to buy while stock prices were low.[19] Robinhood opened three million new accounts in the first quarter of 2020 and reported that the average age of users on its platform was thirty-one, while Charles Schwab reported 609,000 new

9. *See* Reeth, *supra* note 1.
10. *See id.*
11. *See id.*
12. *See id.*
13. *See* Fitzgerald, *supra* note 2.
14. *See* Reeth, *supra* note 1.
15. TD Ameritrade reports that more than 25% of its daily trades come from mobile devices, and E-Trade reports that more than half of its investors under age thirty check their portfolios at least daily. *See* Reeth, *supra* note 1.
16. Fractional shares, as the name implies, are portions of stock that are less than one whole share. Fractional shares are not yet available on all online trading platforms, but several brokers have begun offering them in recent years. *Id. See also Do Mom and Pop Investors Really Need Tesla, Apple Share Splits?*, AL JAZEERA (Aug. 28, 2020), https://www.aljazeera.com/economy/2020/8/28/do-mom-and-pop-investors-really-need-tesla-apple-share-splits.
17. *See* Reeth, *supra* note 1.
18. *See* Ben Winck, *Retail Traders Make Up Nearly 25% of the Stock Market Following COVID-driven Volatility, Citadel Securities Says*, BUS. INSIDER (Jul. 9, 2020), https://markets.businessinsider.com/news/stocks/retail-investors-quarter-of-stock-market-coronavirus-volatility-trading-citadel-2020-7-1029382035.
19. *See* Reeth, *supra* note 1.

accounts, setting a record for the brokerage.[20] By March 2021, Larry Tabb, a market structure analyst at Bloomberg Intelligence, estimated that retail investors accounted for 23% of all U.S. stock market activity.[21] Many of these new investors were millennials with more time on their hands when the country shut down with stay-at-home orders.[22] Popular forms of entertainment, such as sports, concerts, and live TV, were halted, and employers shifted to a work-from-home model,[23] exponentially increasing the average American's free time.

Such growth in the online broker-dealer market is generally viewed as a good thing.[24] As competition increases among broker-dealers, lowering costs and leading to technological advances, the accessibility of the stock market to retail investors grows.[25] Robinhood itself was founded with the mission to "democratize finance for all."[26] In a letter to lawmakers, David Dusseault, the President and COO of Robinhood Financial LLC, explained that the company fundamentally believes that "participation in the U.S. capital markets is empowering."[27] Robinhood aims to use one of the "best available tools for individual wealth creation," the stock market, to provide Americans with a way to take greater ownership of their financial future.[28] As more players enter the market, Robinhood anticipates that the "gap between the 'haves' and the 'have-nots'" will shrink and lead to a more robust economy.[29]

Retail investors' activity in the market can also have significant impacts on the companies they are investing in.[30] Retail investors tend to drive overall

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20. *See id.* Robinhood has also reported that half of its new customers in 2020 are first-time investors. *See* 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.

21. *See* Katie Martin and Robin Wigglesworth, *Rise of the Retail Army: The Amateur Traders Transforming Markets*, FIN. TIMES (Mar. 9, 2021), https://www.ft.com/content/7a91e3ea-b9ec-4611-9a03-a8dd3b8bddb5.

22. *See* Reeth, *supra* note 1.

23. Additionally, the $1,200 stimulus package checks put more cash into Americans' hands just as the market was rebounding 18% in the second quarter of 2020. *See id.*

24. *See* 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.

25. Tim Welsh, CEO of Nexus Strategy, told CNBC, "I think a lot of the innovation around trading commissions has really driven the accessibility of the markets for everyone." *See* Klender, *supra* note 1.

26. *See Careers, supra* note 4.

27. *See* Letter from David Dusseault, President and COO, Robinhood, to Brad Sherman et. al., Rep. H.R. (Aug. 7, 2020).

28. *See id.*

29. *See id.*

30. *See* Edward Ongweso Jr., *Tesla and Apple Stock Split, Investors Crash Robinhood, Nothing Makes Sense*, VICE (Aug. 31, 2020), https://www.vice.com/en_us/article/3azeeb/tesla-and-apple-stock-split-investors-crash-robinhood-nothing-makes-sense; *see also* Kelly Anne Smith, *Robinhood & Hertz: The Troubling Saga of a Bankrupt Stock*, FORBES (June 24, 2020), https://www.forbes.com/advisor/investing/robinhood-bankrupt-hertz/; Jacob Kastrenakes, *Zoom Saw a Huge Increase in Subscribers – and Revenue – Thanks to the Pandemic*, THE VERGE (June 2, 2020),

market sentiment[31] and can certainly be viewed as one of the major sources of liquidity in the market.[32] Take, for example, the stock splits of both Apple and Tesla in August 2020. Following both companies' announcements, their stock prices surged for weeks, and in the hours after the splits went into effect, both companies added billions of dollars to their market capitalizations.[33] On the day of the split, several major trading platforms experienced issues and outages due to the surge in demand, demonstrating the high level of activity on the part of retail investors.[34] This sizeable reaction is noteworthy given that stock splits are only cosmetic changes to stock prices that do not reflect any fundamental changes in a company's earnings, cash flow, or value.[35] This would seem to suggest that retail investors place some sort of intrinsic value on owning full shares (as opposed to fractional shares) of companies and a greater number of these full shares, despite the fact that there should be no difference in their expected return from an economic standpoint.

Additionally, as mentioned above, this surge in investing while prices were down has sent shares of bankrupt and struggling companies soaring.[36] On May 22, 2020, Hertz, the second-largest car rental agency in the country, filed for Chapter 11 bankruptcy as a result of the COVID-19 pandemic's effect on the company's revenue.[37] As is typical following a bankruptcy filing, Hertz's stock price plummeted to around $0.56 per share.[38] However, between May 26 and June 8, its share price increased nearly 900%, reaching $5.53 per share – an unexpected (and seemingly illogical) occurrence after a bankruptcy filing.[39] As trading professionals watched this strange market reaction in horror, it quickly became apparent that retail investors served as a significant force behind the phenomenon.[40] According to Robinhood's previously publicly available data on its users' holdings and trading activity,[41] the number of Robinhood accounts owning shares of Hertz jumped

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https://www.theverge.com/2020/6/2/21277006/zoom-q1-2021-earnings-coronavirus-pandemic-work-from-home; Jones, *supra* note 3.

31. *See* Adam Hayes, *Retail Investors*, INVESTOPEDIA (Feb. 17, 2021), https://www.investopedia.com/terms/r/retailinvestor.asp.

32. *See* Winck, *supra* note 18.

33. As of August 31, 2020, Tesla was up 70% since its announcement on August 11, and Apple was up 32% since its announcement on July 30, 2020. *See* Ongweso, *supra* note 30.

34. *Id.*

35. *See* Egan, *supra* note 20.

36. *See* Reeth, *supra* note 1; Jones, *supra* note 3.

37. *See* Smith, *supra* note 30.

38. *See id.*

39. *See id.*

40. *See id.*

41. Robinhood previously published information to the public about trends in investor activity on its platform, including the number of accounts that held a particular stock, but in August 2020, it stopped this practice. *See* Jeff John Roberts, *Robinhood Will No Longer Share Stock 'Popularity Data' With Sites Like Robintrack*, FORTUNE (Aug. 10, 2020), https://fortune.com/2020/08/10/robinhood-popularity-data-robintrack-stock-market-trading-tracker/.

from nearly 43,000 pre-bankruptcy filing to nearly 171,000 by mid-June.[42] Professionals viewed this response as "irrational exuberance" by retail investors who did not understand that the shares would probably lead to a total loss.[43] Regardless of the advisability of their actions, retail investors clearly helped to prop up Hertz's stock price at a time when it was worth next to nothing, further demonstrating their lack of market knowledge and experience.[44]

Another example that serves to illustrate the effect of retail investors' unchecked enthusiasm on public companies can be seen with what happened in March 2020 with the stock prices of Zoom Technologies and Zoom Video Communications.[45] As the COVID-19 pandemic shutdown forced workplaces and schools to quickly switch to online environments, Zoom Video Communication's video-conferencing platform quickly grew in popularity.[46] Presumably hoping to purchase shares of the growing company, investors rushed to purchase shares with the ticker "ZOOM."[47] What they likely did not realize was that this ticker belonged to Zoom Technologies, and not to Zoom Video Communications (whose ticker is "ZM").[48] Over the course of just a few days, Zoom Technologies' shares rose 1,800% before the SEC froze trading.[49] The SEC cited "concerns about investors confusing this issuer with a similarly named Nasdaq-listed issuer."[50] Two weeks later, when it resumed trading with the new ticker "ZTNO," Zoom Technologies' shares returned to their pre-pandemic prices.[51] This temporary surge in Zoom Technologies' stock price, at a time when the company had made no public disclosures in several years,[52] is illogical and highlights the lack of knowledge and experience of many retail investors who are now actively participating in the stock market.

However, the most well-known and startling example of retail investors' newfound ability to control the stock market is the GameStop meme stock

42. *See* Smith, *supra* note 30.

43. *See id.*

44. On June 30, 2021, Hertz successfully exited bankruptcy after eliminating almost all its corporate debt and was able to provide a payout to shareholders: this is something very unusual in Chapter 11 cases. *See* Andrew Bary, *Hertz Exits Bankruptcy. What Investors Can Expect.*, BARRON'S (June 30, 2021), https://www.barrons.com/articles/hertz-shares-rise-as-bankruptcy-exit-approaches-51625078681.

45. *See* Kastrenakes, *supra* note 30.

46. *See id.*

47. *See* Thomas Yeung, *What Hertz Stock Says About the Perils of Investing in the Robinhood Era*, INVESTORPLACE (July 24, 2020), https://investorplace.com/2020/07/hertz-stock-perils-of-investing-robinhood/.

48. *See id.*

49. *See id.*

50. *See* Jen Wieczner, *'ZOOM' Stock Halted After Investors Confuse It With Zoom Video Stock*, FORTUNE (Mar. 26, 2020), https://fortune.com/2020/03/26/zoom-stock-halt-zm-ticker/.

51. *See* Yeung, *supra* note 47.

52. *See* Denham Sadler, *Zoom Stock Mix-up Results in Trading Halt*, ACS INFORMATIONAGE (Mar. 31, 2020), https://ia.acs.org.au/article/2020/zoom-stock-mix-up-results-in-trading-halt.html.

frenzy of January 2021. In late 2020, retail investors, communicating on the social media site Reddit, started buying shares of GameStop, a video game retailer whose outdated business model had led its stock price to decrease to $3 from $50 in 2014.[53] By December, the stock price was back up to around $20 which grabbed the attention of several hedge fund analysts who found the stock to be overpriced and began shorting the stock, betting that the price would fall again as the market corrected itself.[54] However, users on the Reddit page known as WallStreetBets saw this activity and rallied together to buy and hold more GameStop stock in order to push the stock price higher and cause significant losses for the hedge funds.[55] During the month of January 2021, GameStop saw its stock price peak at $483 due to this surge in activity headed by retail investors, at which point Robinhood halted purchases of GameStop and other similarly surging stocks on its platform.[56] This dramatic and unfounded rally is estimated to have cost hedge funds almost $20 billion before the stock price returned to a more reasonable amount.[57]

Most concerning of all, this entire frenzy was not necessarily the result of any beliefs that GameStop as a company was fundamentally worth $483 per share.[58] The plan to buy and hold the stock was formulated on WallStreetBets by a significant enough number of retail investors who simply wanted to beat the hedge funds at their own game.[59] Other struggling companies shorted by hedge funds, such as AMC Entertainment and BlackBerry, were also targeted by these same users and saw dramatic increases and volatility in their stock prices.[60] While many of these retail investors were able to cash in and see significant profits, others took out significant loans and bet most of their savings on these stocks, only to lose almost everything they put in.[61]

Robinhood critics cite to these and other concerns as examples for why greater regulation is needed over the broker-dealer. Most seem to argue that Robinhood's $0 commissions business model and user interface, whose design attracts young, inexperienced investors to trading products that are

53. *See* Jones, *supra* note 3.

54. *See id.*

55. *See id.*

56. *See id.*

57. *See id.* In the week following this frenzy, GameStop's stock price tumbled to around $50 as the "unsustainable bullish sentiment" of the retail investors waned and many began selling their positions. *See id.*

58. *See* Martin and Wigglesworth, *supra* note 21.

59. *See* Jones, *supra* note 3; Martin and Wigglesworth, *supra* note 21.

60. *See* Yun Li, *GameStop, Reddit and Robinhood: A Full Recap of the Historic Retail Trading Mania on Wall Street*, CNBC (Jan. 30, 2021), https://www.cnbc.com/2021/01/30/gamestop-reddit-and-robinhood-a-full-recap-of-the-historic-retail-trading-mania-on-wall-street.html.

61. *See* Rachel Louise Ensign, *GameStop Investors Who Bet Big – and Lost Big*, WALL ST. J. (Feb. 15, 2021), https://www.wsj.com/articles/gamestop-investors-who-bet-bigand-lost-big-11613385002.

often reserved for experienced investors, "gamifies" stock trading.[62] Further, complex trading products, like options, are just a few clicks and swipes away from most users, and it is difficult to find guidance on how to use these products.[63] Indeed, the simplicity of the app inherently means that there is limited information and few tools available to customers when making investment decisions.[64] The interface, which makes continuing a trade easier than canceling it and provides a list of the most popular stocks on its home page, appears to use behavioral nudges to promote active trading.[65] Behavioral nudges and gamification like this can be used to achieve positive outcomes like eating healthier and saving more money.[66] Gamification, when implemented properly, is one of the strongest arguments for how to engage and educate retail investors.[67] However, as Investopedia points out, "when these nudges, notifications, achievements, and other psychological tools are turned toward investing … it erases the already thin line between playing the market and playing the slots."[68] Robinhood makes it "too easy, and too fun, to wager money on stocks and more complicated investments."[69]

This leads critics to question the ethics of Robinhood's business model.[70] Robinhood has sold itself on the story of helping the "little guy" by taking from the rich (the Street) to give to the poor (retail investors).[71] However, the

62. *See* Dean Seal, *Robinhood Users Blast 'Game-Like Interface' in Amended Suit*, LAW360 (Aug. 24, 2020), https://www.law360.com/articles/1303840/robinhood-users-blast-game-like-interface-in-amended-suit.

63. *See* Christopher Robbins, *Is Robinhood the Hero That Today's Investors Need?*, FIN. ADVISOR (Nov. 1, 2020), https://www.fa-mag.com/news/is-robinhood-the-hero-that-today-s-investors-need-58634.html. Compare this to TradeZero, another commission-free broker-dealer which provides its users with access to fractional shares, options, and margin trading. *See id.* TradeZero does not open margin accounts for users under the age of twenty-one, and the broker-dealer monitors users' activity, intervening when the activity does not match a user's stated risk preferences and goals. *See id.* While comparing the company to Robinhood, TradeZero's founder, Dan Pipitone stated, "We don't want to be synonymous with a dating app where you can just swipe up to trade." *Id.*

64. *See* Chen, *supra* note 24.

65. In fact, "Robinhood users traded 40 times the number of shares as Charles Schwab customers and nine times that of E*Trade users in the first quarter of 2020, as measured by share per dollar in customer accounts." Bieber, *supra* note 5.

66. *See* Chen, *supra* note 24.

67. *See* Annie Massa and Edward Robinson, *Robinhood's Role in the 'Gamification' of Investing*, BLOOMBERG WEALTH (Dec. 19, 2020), https://www.bloomberg.com/news/articles/2020-12-19/robinhood-s-role-in-the-gamification-of-investing-quicktake.

68. Chen, *supra* note 24.

69. Massa and Robinson, *supra* note 67. In response to this scrutiny, Robinhood has taken steps like adding more educational resources to its platform and removing the once-notorious confetti burst that was seen when a user placed a trade. *See* Fitzgerald, *supra* note 2.

70. *See* Salzman, *supra* note 6.

71. *See* Jeff Kauflin, Antoine Gara, and Sergei Klebnikov, *The Inside Story of Robinhood's Billionaire Founders, Option Kid Cowboys and the Wall Street Sharks That Feed on Them*, FORBES (Aug. 19, 2020), https://www.forbes.com/sites/jeffkauflin/2020/08/19/the-inside-story-of-robinhoods-billionaire-founders-option-kid-cowboys-and-the-wall-street-sharks-that-feed-on-them/?sh=e5c6169268dc.

broker-dealer earns most of its revenues through payment-for-order flow.[72] This leads to a possible conflict of interest: the more Robinhood encourages users to trade (through the behavioral nudges discussed above), the more revenue it stands to generate.[73] Even more concerning is that "academic research has shown that self-guided investors do worse the more actively they trade."[74] With such a business model, it would seem Robinhood is actually "selling the little guy to rich market operators."[75] In December 2020, Robinhood agreed to a $65 million settlement with the SEC over charges that it failed to disclose its relationships with the firms it utilized to process trades and that it failed to seek the "best reasonably available terms" when executing customer orders.[76] By completing customer trades at less-than-optimal prices, Robinhood is estimated to have robbed customers of $34.1 million.[77] In June 2021, FINRA hit the company with a record-breaking $70 million fine due to "years of regulatory issues and negligence" and for misleading its customers.[78] Further, as a result of the halted trading implemented at the height of the GameStop frenzy, Robinhood is now facing several class action lawsuits alleging that it "broke [its] promise with users to let them trade as they saw fit."[79] Others allege the restrictions were implemented in order to protect the hedge funds it has relationships with.[80] Regardless of the morality of its operations, investors appear somewhat eager to back Robinhood.[81] The company went public in July 2021 with an initial valuation of $32 billion, and though it was initially a volatile IPO by normal standards,[82] the valuation has generally hovered around $40 billion since.[83]

The problem with all of this active trading (resulting from the accessibility that Robinhood provides its users to the stock market) is that it leads to higher volatility and speculation which can unnerve even

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72. Payment for order flow is "a common although controversial practice whereby a broker receives compensation and other benefits for directing orders to different parties for trade execution." *See* Matthew Johnson, *How Robinhood Makes Money*, INVESTOPEDIA (Sept. 10, 2020), https://www.investopedia.com/articles/active-trading/020515/how-robinhood-makes-money.asp.

73. *See id.*

74. Massa and Robinson, *supra* note 67.

75. *See* Kauflin, Gara, and Klebnikov, *supra* note 71.

76. *See* Chris Isidore and Matt Egan, *Robinhood Agrees to Pay a $65 Million Fine for Deceiving Clients*, CNN BUS. (Dec. 17, 2020), https://www.cnn.com/2020/12/17/investing/robinhood-sec-settlement-deceptive-practices/index.html.

77. *See id.*

78. *See* Myers, *supra* note 5.

79. *See* Andrew Keshner, *Lawsuits Against Robinhood in the GameStop Saga are Getting Their Day in Court – but There's One Big Snag*, MARKETWATCH (Apr. 21, 2021), https://www.marketwatch.com/story/lawsuits-against-robinhood-in-the-gamestop-saga-are-getting-their-day-in-court-but-theres-one-big-snag-11618806321.

80. *See id.*

81. *See* discussion *infra* notes 82-83.

82. *See* Myers, *supra* note 5.

83. *See Robinhood Markets Inc.*, GOOGLE FIN., https://www.google.com/finance/quote/HOOD:NASDAQ (last visited Aug. 18, 2021).

experienced investors.[84] Nicholas Colas, the co-founder of DataTrek Research and a thirty-year Wall Street veteran, described the Robinhood crowd as "a million minnows in a lake. You know that individually they are small but then you see a mass of them and it's impressive."[85] Just as the examples above demonstrate, there is simply strength in numbers.[86]

In December 2020, citing to many of the concerns raised above, regulators in the Massachusetts Securities Division filed a complaint against Robinhood.[87] The complaint charges the company with failing to act in the best interests of its customers.[88] Specifically, the complaint points out Robinhood's "aggressive tactics to attract inexperienced investors" and "its use of gamification strategies to manipulate customers."[89] In a statement released with the complaint, regulators reported that 68% of Robinhood's accounts in Massachusetts were approved for options trading, despite the customers having reported limited or no investing experience,[90] which would be in violation of Robinhood's own rules for account approval.[91] The complaint alleges that Robinhood encourages "continuous and repeated engagement with its application," providing an example of one customer, with no prior investment experience, who was permitted to make over 12,700 trades in just over six months.[92] Secretary of the Commonwealth of Massachusetts, William Galvin, stated that "treating this like a game and luring young and inexperienced customers to make more and more trades is not only unethical, but also falls far short of the standards we require in Massachusetts."[93]

84. *See* Yeung, *supra* note 47.

85. Egan, *supra* note 20.

86. *But see* Sarah Ponczek, *Robinhood Users Weren't as Reckless as Portrayed During Rally*, BLOOMBERG L. (Sept. 29, 2020), https://www.bloomberg.com/news/articles/2020-09-29/robinhood-users-are-a-bit-less-nuts-than-you-were-led-to-believe (showing results from a working paper published by the National Bureau of Economic Research which supports the theory that retail investor activity actually helped stabilize the stock market during the COVID-19 crash).

87. *See* Pippa Stevens, *Massachusetts Regulators File Complaint Against Robinhood, Alleging Manipulation of Customers*, CNBC DISRUPTOR 50 (Dec. 16, 2020), https://www.cnbc.com/2020/12/16/robinhood-reportedly-facing-complaint-by-massachusetts-regulators-over-targeting-young-users.html.

88. *See id.*

89. *See id.*

90. *See id.*

91. *See* Caitlin McCabe, *Massachusetts Regulators File Complaint Against Robinhood*, WALL ST. J. (Dec. 16, 2020), https://www.wsj.com/articles/massachusetts-regulators-to-file-complaint-against-robinhood-11608120003.

92. *See id.*

93. *See* Stevens, *supra* note 87.

II: UNDERSTANDING COMPLEX AND HIGH-RISK TRADING PRODUCTS

A. THE DANGERS OF COMPLEX TRADING PRODUCTS

Too much access, without adequate protections in place, can lead to dangerous consequences for retail investors with limited knowledge and experience in the stock market. As noted above, Robinhood has come under the scrutiny of several lawmakers and is facing a wrongful-death lawsuit following the suicide of one of its users, Alexander Kearns.[94] Kearns, a college student, had been approved to trade options using margin,[95] and his account balance showed a negative $730,000 balance after performing a complex options trade.[96] In his suicide note, Kearns described himself as a "20-year-old with no income"[97] and further wrote that he was distressed by the balance and had "no idea what [he] was doing now in hindsight."[98] It appears that, in fact, the balance did not reflect an actual liability and was only representative of a portion of the options trade that was performed.[99]

Following this heartbreaking news, six members of Congress sent a letter to Robinhood outlining several of their concerns about training and safeguards for its customers.[100] They began the letter by pointing out, "by seeking to cultivate a customer base of relatively inexperienced investors, you have also taken on an especially great responsibility to make sure your customers are protected."[101] The members of Congress acknowledged that, in response to the tragedy, Robinhood announced planned improvements to its options trading interface, but they questioned "whether these proposed changes will have any meaningful impact on the ways your platform enables and encourages inexperienced investors to engage in high risk trading."[102] The letter then demanded answers to ten questions relating to the account approval process, specifically focusing on the eligibility criteria utilized by Robinhood.[103]

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94. *See* Salzman, *supra* note 6; Kolhatkar, *supra* note 5.

95. Options and margin trading are explained below in Part II.B. Options can quickly be explained as contracts which give their owners rights to buy or sell 100 shares at a certain price up until a certain date. Margin trading can quickly be described as borrowing money from a broker in order to buy securities and using those securities and funds in the investment account as collateral for the loan. The combination of these two trading products dramatically amplifies an investor's risks. *See infra* notes 110-132 and accompanying text.

96. *See* Letter from Brad Sherman et. al., Rep. H.R., to Vladimir Tenev, Co-Founder and Co-CEO, Robinhood and Raiju Bhatt, Co-Founder and Co-CEO, Robinhood (July 13, 2020).

97. *See id.*

98. *See* Salzman, *supra* note 6.

99. *See id.*

100. *See* Letter from Brad Sherman et. al. to Vladimir Tenev, *supra* note 96.

101. *Id.*

102. *Id.*

103. *See id.*

In defense, Robinhood stated that not only was it in compliance with applicable FINRA rules governing broker-dealers and these high-risk product offerings, but that it was going above and beyond those requirements to improve education and clearance levels on the platform.[104] Robinhood answered the specific questions, explaining its plans to implement additional eligibility criteria for more complex options trades and its consideration of strengthening its financial requirements as well.[105] However, Robinhood did not outline its exact procedures for analyzing the self-reported data points that it collects from its customers at account opening.[106] Subsequently, Representative Sean Casten, one of the lawmakers included in the correspondence, said Robinhood's response letter was inadequate and that its claims of compliance with existing laws alone was not sufficient.[107]

B. How Do These Products Work?

As noted above, Robinhood is currently facing increased scrutiny and investigations, not only from lawmakers, but also from the SEC and FINRA, as well as several class action lawsuits from its own customers.[108] In fact, the company has actively recruited top legal talent from other financial firms such as Wells Fargo & Co. and Goldman Sachs Group, Inc. to help it fight these mounting actions.[109] One of the main concerns of these parties (and the critics mentioned above) is the ease of access Robinhood provides its users to two types of complex and high-risk trading products: options and margin trading.[110] In order to fully understand these criticisms and the dangers posed by retail investors' almost unregulated access to these trading products, it is helpful to establish a basic understanding of how they work and the potential benefits and downsides of each.

Stock options are contracts which give their owners rights to buy or sell 100 shares at a certain price (the "strike price") up until a certain date (the "expiration date").[111] Options contracts that allow the owner to buy shares are "call" options, and options contracts that allow the owner to sell shares are "put" options.[112] An option owner pays a premium for this right and will choose to exercise the option (or sell it to another investor) if the price of the

104. *See* Letter from David Dusseault to Brad Sherman et. al., *supra* note 27.

105. *See id.*

106. *See id.*

107. *See* Salzman, *supra* note 6.

108. *See* Bieber, *supra* note 5; Myers, *supra* note 5.

109. *See* Brian Baxter, *Robinhood Raids Goldman, Wells Fargo, Ameritrade for Legal Pros*, BLOOMBERG L. (Dec. 2, 2020), https://news.bloomberglaw.com/business-and-practice/robinhood-raids-goldman-wells-fargo-ameritrade-for-legal-pros.

110. *See* Letter from Brad Sherman et. al. to Vladimir Tenev, *supra* note 96; Caitlin Reilly, *Death Draws Lawmakers' Scrutiny to Robinhood's Trading App*, ROLL CALL (July 28, 2020), https://www.rollcall.com/2020/07/28/death-draws-lawmakers-scrutiny-to-robinhoods-trading-app/.

111. *See What Is an Option?*, ROBINHOOD (Jan. 6, 2021), https://learn.robinhood.com/articles/4q86vJm1iPRWhoPVzvD63r/what-is-an-option/.

112. *See id.*

underlying stock is on the correct side of the strike price.[113] This is known as being "in the money" (for call options, when the strike price is below the stock price, and for put options, when the strike price is above the stock price).[114] The reverse, when the strike price of a call option is above the stock price, or the strike price of a put option is below the stock price, is known as being "out of the money."[115] When the stock price and strike prices are equal, the option is said to be "at the money."[116] Investors will only have an incentive to exercise their options when they are in the money, which means they can buy or sell the underlying stock at a better price than if they bought or sold the same on the open market.[117]

Given that the upfront financial commitment of options, the premium, is significantly lower than the cost of purchasing the shares on the open market, options allow retail investors to access the gains available from share price fluctuations without having to fork out the total share cost upfront.[118] Options owners are not required to exercise the option if the share prices move in the opposite direction than they were anticipating, so their losses are limited to the premium they paid.[119] This seems to provide retail investors with unlimited upside and the risk of only a small amount of loss.[120]

Margin trading involves borrowing money from a broker in order to buy securities and using those securities and funds in the investment account as collateral for the loan.[121] The borrower is responsible for periodic interest payments during the term of the loan.[122] Regulation T of the Federal Reserve Board allows borrowing up to 50% of the purchase price of the securities, but some brokers may have a higher initial margin requirement.[123] Once the securities have been purchased, FINRA requires a minimum 25% maintenance margin at all times, but most brokers will require a maintenance margin between 30-40% or even higher.[124] Margin calls occur when an investor's account falls below the broker's maintenance margin requirement; at that point, the investor will need to deposit more cash or securities into the account or sell some of the securities in order to bring the margin in line with the requirement.[125]

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113. *See id.*
114. *See id.*
115. *See id.*
116. *See id.*
117. If not exercised or sold, most options expire with no value. *See id.*
118. *See id.*
119. *See id.*
120. *See id.*
121. *See What Is Margin?*, ROBINHOOD (Dec. 7, 2020), https://learn.robinhood.com/articles/what-is-margin/.
122. *See id.*
123. *See Margin: Borrowing Money to Pay for Stocks,* U.S. SEC. & EXCH. COMM'N (Apr. 17, 2009), https://www.sec.gov/reportspubs/investor-publications/investorpubsmarginhtm.html.
124. *See id.*
125. *See id.*

Buying securities on margin boosts an investor's purchasing power and increases the size of the investment, allowing the investor to potentially magnify their expected returns.[126] Investors can also use this mechanism to diversify their existing portfolios by purchasing securities in different firms and industries without needing to sell the securities they already own.[127] Nevertheless, margin can amplify an investor's losses just as significantly as it can amplify their gains.[128] If the value of the securities begins to fall, the investor will be required to deposit more funds or sell the securities at the depressed price, and, just as with other loans, the investor must still repay the loan with interest, regardless of the outcome.[129]

When an investor combines these two products to buy and/or sell options on margin, as Alexander Kearns did, the potential gains and losses are considerably amplified.[130] There are multiple ways in which the two can be combined.[131] The one at issue in Kearns's case, a "bull put spread," involves simultaneously purchasing and selling put options, which the members of Congress described in their letter as a trade that could "reasonably [result] in major investment losses."[132] Generally, the combination of options' expiration dates with margin calls can cause an investor to lose everything, even more than they invested, if the market moves against them in the short term.[133]

Futures trading, another product not currently offered on Robinhood but worth discussing for the purposes of this Note,[134] has similar high-risk characteristics and is offered on several other broker platforms.[135] A futures contract is an agreement today between two parties on the price, quantity, and future delivery date of securities.[136] Whereas options give the buyer "the right, but not the obligation," to buy or sell the securities, futures impose

126. *See What Is Margin?*, *supra* note 121.

127. *See Understanding the Benefits and Risks of Margin*, FIDELITY, https://www.fidelity.com/learning-center/trading-investing/trading/understanding-benefits-risks-margin (last visited Dec. 19, 2020).

128. *See What Is Margin?*, *supra* note 121.

129. *See id.*

130. *See* Reilly, *supra* note 110.

131. *See* James Chen, *Option Margin*, INVESTOPEDIA (Mar. 27, 2021), https://www.investopedia.com/terms/o/option-margin.asp.

132. Letter from Brad Sherman et. al. to Vladimir Tenev, *supra* note 96.

133. *See* Jeremy Bowman, *What is Margin & Should You Invest On It?*, MOTLEY FOOL (July 14, 2021), https://www.fool.com/investing/2020/06/07/options-margin-and-other-risky-investment-practice.aspx.

134. *See Help Center Investing*, ROBINHOOD, https://robinhood.com/us/en/support/trading (last visited Oct. 9, 2020).

135. *See* Chris Davis, *6 Best Online Brokers for Futures Trading and Commodities of August 2021*, NERDWALLET (June 7, 2021), https://www.nerdwallet.com/blog/investing/best-online-brokers-futures-trading-commodities/.

136. *See What Are Futures?*, ROBINHOOD (Sept. 22, 2020), https://learn.robinhood.com/articles/what-are-futures/.

obligations to buy and sell on both parties to the contract.[137] If the price of the securities increases, the buyer stands to profit and the seller to lose out, and vice versa when the price of the securities decreases.[138] Because futures contracts can be, and typically are, purchased on margin, the potential gains and losses are indefinite.[139] As discussed below, all of these complex and high-risk trading products are regulated by FINRA rules.[140]

III: CURRENT FINRA RULES

All the risks associated with options, margin trading, and futures become much more concerning when viewed in light of the current FINRA rules surrounding the account opening and approval process for broker-dealers. These rules provide guidelines for the information to be collected from investors before account opening, but they fail to provide any specific methodology to be utilized when assessing that data.[141] Further, the information that is collected is self-reported by the investor,[142] and broker-dealers are only expected to "seek to obtain" it, while making note in their records of any investor refusal to provide.[143] Due to the lack of guidance from FINRA, broker-dealers differ in their approval and denial rationales, with certain companies like Robinhood appearing to be more lenient about who is allowed to access complex products.[144]

The requirements for opening and approving options trading accounts are outlined in FINRA Rule 2360(b)(16).[145] In order to perform the due diligence required to "ascertain the essential facts relative to the customer, his financial situation and investment objectives," broker-dealers must "seek to obtain" certain self-reported information "at a minimum."[146] This includes the investor's age, marital status, employment status, investment objectives, investment experience and knowledge, estimated annual income, net worth, and liquid net worth.[147] The Rule provides that when a customer refuses to provide any of this information, the broker-dealer need only make notes indicating this in the customer's records before considering the information which was provided in order to approve or disapprove the account for options trading.[148] Further, the verification process for the reported information only

137. *See Options vs. Futures: What's the Difference?*, INVESTOPEDIA (June 1, 2021), https://www.investopedia.com/ask/answers/difference-between-options-and-futures/.

138. *See id.*

139. *See* Jason Fernando, *Futures*, INVESTOPEDIA (Aug. 9, 2021), https://www.investopedia.com/terms/.asp.

140. *See* discussion *infra* notes 141–171.

141. *See* Reilly, *supra* note 110; Salzman, *supra* note 6.

142. *See* Salzman, *supra* note 6.

143. *See* FINRA Rule 2360(b)(16) (amended 2020).

144. *See* Reilly, *supra* note 110; Salzman, *supra* note 6.

145. *See* FINRA Rule 2360(b)(16) (amended 2020).

146. *See* FINRA Rule 2360(b)(16)(B)-(B)(i) (amended 2020).

147. *See id.*

148. *See* FINRA Rule 2360(b)(16)(B)(iv) (amended 2020).

entails sending it back to the investor within fifteen days of account approval; unless the investor responds with any corrections, the information is considered verified.[149] Broker-dealers are also required to obtain the investor's written agreement, which indicates that they are "aware of and [agree] to be bound by FINRA rules applicable to the trading of option contracts," among other things.[150]

The requirements for opening and approving futures trading accounts, which are substantially similar to those for options trading accounts, are outlined in FINRA Rule 2370(b)(16).[151] The due diligence process is identical, with customers self-reporting their information and broker-dealers making note of any data the customers refused to provide.[152] The verification process is the same, but it is not required if the information was previously verified in connection with the approval of an options trading account.[153] A written account agreement is still required, this time indicating the investor's awareness of, and agreement to be bound by, FINRA's security futures trading rules.[154] The only significant difference between Rule 2360(b)(16)(B)(i) and Rule 2370(b)(16)(B) is that broker-dealers must "establish specific minimum net equity requirements for initial approval and maintenance of customers' security futures accounts" due to futures accounts' connection with margin trading.[155]

Margin trading account requirements are contained in several places, including Federal Reserve Board Regulation T and FINRA Rule 4210.[156] Regulation T sets the initial margin requirements, and FINRA Rule 4210 supplements these requirements by establishing maintenance margin requirements.[157] When an investor applies for a margin account, the broker-dealer will evaluate information such as income, net worth, and liquidity, and a credit check may also be required in some circumstances.[158] For investors already approved for options or futures trading, the broker-dealer usually will not need to collect any additional information.[159] However, FINRA Rule 4210(b) requires an investor to deposit a minimum of $2,000 to open a margin account.[160]

149. *See* FINRA Rule 2360(b)(16)(C) (amended 2020).
150. *See* FINRA Rule 2360(b)(16)(D) (amended 2020).
151. *See* FINRA Rule 2370(b)(16)(B) (amended 2019).
152. *See id.*
153. *See* FINRA Rule 2370(b)(16)(C) (amended 2019).
154. *See* FINRA Rule 2370(b)(16)(D) (amended 2019).
155. *See id.*
156. *See Margin Account Requirements*, FINRA, https://www.finra.org/rules-guidance/key-topics/margin-accounts (last visited Oct. 22, 2020).
157. *See id.*
158. *See* Lance Cothern, *Should You Open a Cash or Margin Brokerage Account?*, MY BANKTRACKER (June 1, 2021), https://www.mybanktracker.com/blog/investing/margin-account-302602.
159. *See* FINRA Rule 4210 (amended 2016).
160. FINRA Rule 4210(b) (amended 2016).

One of the concerns with these rules is that they do not provide broker-dealers with any guidance on how to analyze the information they collect from investors, leaving each to develop its own methodology for account approval. Due to expected wide-ranging methods in how each broker-dealer chooses to evaluate customer data given this lack of direction, researchers have been unable to determine the underlying rationale for how accounts are approved or denied among the different firms.[161] Given the risks surrounding these high-risk trading products, it is troubling that FINRA has not provided more specific guidelines outlining how the customer data points should be weighed and analyzed when making an account approval decision.

Another problem with these Rules, as they stand now, is that customers self-report all of the requested information, and broker-dealers are only required to verify the information with the customer.[162] While the question of whether it should be necessary for broker-dealers to verify any of the information with third-party sources is beyond the scope of this Note, this is even more concerning in light of the "seek to obtain" language of the Rules. Broker-dealers have the discretion to potentially open accounts in cases where the customer has refused to provide requested information. If the goal is safer access to certain trading products that require more scrutiny, customers should not have the right to refuse to provide information; it should be mandatory for account approval.

It should also be noted that FINRA Rule 2111 (Suitability) does not apply to broker-dealers like Robinhood who do not make investment recommendations to their customers.[163] The Suitability Rule requires that broker-dealers "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [broker-dealer] to ascertain the customer's investment profile."[164] This investment profile consists of much of the information the broker-dealer seeks to obtain at account opening, discussed above.[165] This requirement places a responsibility on broker-dealers to deal fairly and ethically with their customers. Robinhood's platform is designed to allow investors to only participate in self-directed investing and trading, permitting it to totally avoid compliance with this Rule.[166]

However, in the complaint filed by the Massachusetts Securities Division, regulators argue that Robinhood should be subjected to a suitability analysis and duty of loyalty as the trading platform currently stands.[167] While

161. *See* Salzman, *supra* note 6.
162. *See* FINRA Rule 2360(b)(16).
163. *See* Letter from David Dusseault to Brad Sherman et. al., *supra* note 27.
164. FINRA Rule 2111(a) (amended 2020).
165. *See id.*
166. *See* Letter from David Dusseault to Brad Sherman et. al., *supra* note 27.
167. *See* McCabe, *supra* note 91.

Robinhood argues that it does not make investment recommendations to its customers,[168] the regulators argue that its lists of top moving stocks and the 100 most popular stocks being traded on the app potentially influence the stocks that customers buy.[169] These "recommendations" are made without Robinhood performing any form of suitability analysis for its customers.[170] In fact, the complaint states, "This is no different from a broker-dealer agent handing a list of securities to a customer, pretending to be surprised when the customer purchases securities from that list, and then proclaiming that he made no recommendations to the customer."[171] Given the above concerns surrounding retail trading and the current rules regarding account opening, there are a few options FINRA should consider in order to protect investors with limited knowledge or experience.

IV: SOLUTION

A. LESSONS TO BE LEARNED FROM FINANCIAL LITERACY PROGRAMS

In the student loan and mortgage industries, where lawmakers have perceived sizeable risks to consumers' financial health, various safeguards have been created with the goal of protecting consumers from their own lack of knowledge and experience.[172] Two instructive examples come from the world of financial literacy: entrance and exit counseling for student loan borrowers and homeownership education courses for certain mortgage borrowers.[173] In both instances, as discussed below, borrowers are required to complete educational courses before executing their loans to ensure they are aware of the risks and the basic mechanics of the contractual agreements they are signing. The fundamental principle behind financial literacy programs such as these is that consumers are less likely to be subjected to fraud, manipulation, or economically unsustainable transactions if they are provided with more knowledge on the front end.[174] Financial literacy has become increasingly important since the 2008 financial crisis, in which many believe financial illiteracy played a major role.[175] Therefore, lawmakers and lenders have implemented these educational programs with the goal of improving consumer financial literacy for the good of the economy overall.[176]

168. *See* Letter from David Dusseault to Brad Sherman et. al., *supra* note 27.
169. *See* McCabe, *supra* note 91.
170. *See id.*
171. *Id.*
172. *See* Kyle Schickel, *Financial Literacy Education: Simple Solutions to Mitigate a Major Crisis*, 45 J.L. & EDUC. 259 (2016); Joseph A. Smith, Jr., *Financial Literacy, Regulation and Consumer Welfare*, 8 N.C. BANKING INST. 77 (2004).
173. *See id.*
174. *See* Schickel, *supra* note 172, at 263.
175. *See id.*
176. *See generally id.; see also* Smith, *supra* note 172.

Colleges and universities are mandated, under 34 C.F.R. § 685.304, to ensure that entrance and exit counseling is conducted with each undergraduate, graduate, or professional student borrowing a federal loan before the loan proceeds are disbursed.[177] The counseling "must provide the borrower with comprehensive information on the terms and conditions of the loan and on the responsibilities of the borrower with respect to the loan."[178] In order to do so, it must "emphasize to the borrower the seriousness and importance of the repayment obligation," "describe the likely consequences of default," and "provide information on how interest accrues and is capitalized," among other things.[179] Given the risks associated with taking out student loans, financial literacy supporters argue that understanding the above concepts will aid students in making informed decisions about how much money to borrow.[180] The federal government seems to agree, given that it has invested time and money to mandate entrance and exit counseling for students.[181] The government acknowledges that the inability of borrowers to repay their student loans can lead to harmful economic effects: lower consumer activity in the market, lower credit scores, and the inability to make down payments on homes, to name a few.[182] In support of the argument that financial literacy is beneficial to borrowers, empirical evidence shows a strong correlation between financial literacy and low student loan default rates.[183]

Similarly, the mortgage lending industry has enacted various educational requirements in connection with certain types of loans. As just one example, in response to the 2008 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires homeownership counseling before borrowers can obtain "high-cost" mortgages as they are defined in the Consumer Financial Protection Bureau's Home Ownership and Equity Protection Act Rule.[184] This counseling requirement also applies to negative amortization loans to first-time homebuyers, which may or may not be high-cost.[185] Given the perceived elevated risks inherent in these types of loans, the Rule requires mortgage loan originators to receive confirmation that the borrower has completed homeownership counseling from a federally

177. 34 C.F.R. § 685.304(a)(1) (2019).

178. *Id.* at § 685.304(a)(3) (2019).

179. *Id.* at § 685.304(a)(6) (2019).

180. *See* Schickel, *supra* note 172, at 262–63.

181. *See id.* at 264.

182. *See id.*

183. *See id.* at 263–64. "Five of the states rated in the top ten of the least financially literate states are also found in the top ten of states with the highest student loan default rate." *Id.*

184. *See* Letter from Debbie Matz, Chairman, National Credit Union Administration, to Federally Insured Credit Unions (Jan. 2014), https://www.ncua.gov/regulation-supervision/letters-credit-unions-other-guidance/new-homeownership-counseling-and-consumer-protection-requirements-cfpb-0.

185. *See id.*

certified or approved counselor.[186] These counseling courses cover topics such as "understanding the mortgage process and required documentation," "budgeting for home repairs and maintenance," and assessing the borrower's credit report.[187] As with entrance and exit counseling for student loans, supporters of homeownership education courses believe the evidence shows these activities are beneficial to the participating borrowers, lenders, and society as a whole.[188] In a perfect market, consumers would make rational decisions with complete information and sufficient bargaining power.[189] However, consumers are not always rational, information is asymmetric between consumers and firms, and financial firms have significantly more bargaining power than consumers.[190] Financial literacy tools, including homeownership counseling courses, serve to improve the consumer marketplace in these regards.[191] Implementing appropriate counseling requirements for retail investors would likely lead to similar results in the online investing realm.

B. PROPOSED CHANGES

With these consumer protection examples in mind, the suggestion that FINRA should modify and improve its guidelines in order to facilitate more protection for retail investors is not far-reaching. First, FINRA should create a more specific account approval process for broker-dealers to utilize when making account opening determinations for accounts with access to options, futures, and margin trading. As the Rules stand now, broker-dealers are left to collect the required information and then devise their own formulas for how to evaluate and weigh the different data points. FINRA should start its modification of the approval process requirements by making customer disclosure of the listed data points mandatory. If a retail investor would like access to these complex and high-risk trading products, they should be required to provide all of the requested information at a minimum. FINRA should also make it clear how each data point is to be evaluated and weighed in the overall approval formula. To illustrate, perhaps a minimum amount of liquid net worth or annual income might be considered for access to these types of accounts. Certain positive factors, like greater investment experience and knowledge, could be used to offset other negative factors like having a low net worth or lower income. Such guidance would ideally be fashioned with the protection of retail investors as the primary goal, instead of leaving

186. *See id.*

187. *Homeownership Education & Housing Counseling*, FANNIE MAE, https://singlefamily.fanniemae.com/originating-underwriting/mortgage-products/homeownership-education-housing-counseling (last visited Oct. 23, 2020).

188. *See* Smith, *supra* note 172, at 98.

189. *See id*. at 97.

190. *See id.*

191. *See id*. at 98.

broker-dealers on their own to create their own evaluation methods, when their incentives will most likely be to approve as many new accounts as possible.

Further, the guidance should allow for the risk rating of customers based on the information they provide. For example, those with little to no investing experience or knowledge should be placed in a higher risk level than those with more investing experience and knowledge. Retail investors in higher risk levels should have more restrictions in place on their accounts, preventing them from easy access to complex and high-risk products. As they gain experience and knowledge, broker-dealers should have guidelines in place to enable investors to move to lower risk levels, with less restrictions, over time. Additionally, for those investors that may feel they have been placed in an inappropriate risk level, a test could be formulated to gauge their investing knowledge and allow them to test into a lower risk level if they are able to demonstrate that they know what they are doing and how these products work.

The SEC should then look at expanding its recently finalized Regulation Best Interest to cover the account approval process in light of these new risk levels. Regulation Best Interest, a rule passed under the Securities Exchange Act of 1934, creates a best interest standard of conduct for broker-dealers when "they make a recommendation to a retail customer of any securities transaction or investment strategy involving securities, *including recommendations on types of accounts*."[192] Broker-dealers are required to make such recommendations while acting in the best interest of the retail investor, at the time of recommendation, without placing their own financial interest ahead of the retail investor's interest.[193] One of the components of the general obligation is the care obligation which requires broker-dealers to "exercise reasonable diligence, care, and skill in making the recommendation."[194] As Robinhood pointed out in its correspondence with the lawmakers mentioned above, because Robinhood's platform currently

192. *SEC Regulation Best Interest (Reg BI)*, FINRA, https://www.finra.org/rules-guidance/key-topics/regulation-best-interest (last visited Nov. 19, 2020) (emphasis added).

193. *See Regulation Best Interest*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/info/smallbus/secg/regulation-best-interest (last visited Nov. 19, 2020).

194. This requirement of reasonable diligence, care, and skill includes broker-dealers (1) understanding "potential risks, rewards, and costs associated with recommendation," and having a "reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;" (2) having a "reasonable basis to believe the recommendation is in the interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation" while not placing "the interest of the broker-dealer ahead of the interest of the retail customer;" and (3) having a "reasonable basis to believe that a series of recommended transactions, even if in the retail customer's best interest when viewed in isolation, is not excessive and is in the retail customer's best interest when taken together in light of the retail customer's investment profile." *Id.* The care obligation also requires broker-dealers to apply additional heightened scrutiny when making recommendations concerning high-risk trading products. *See id.*

offers the same account to all users and does not make transaction or investment strategy recommendations to its customers, this SEC regulation does not apply.[195] However, if the above-proposed risk levels are implemented, the SEC should expand its Regulation Best Interest to cover broker-dealers' decisions about (1) what risk level to place an individual customer in and (2) when to recommend a lower risk level account to an individual customer. The implementation of different risk levels within accounts, and especially a suggestion to move to a different risk level upon gaining sufficient experience, could easily be perceived as broker-dealers making account recommendations. The requirement across the board for all broker-dealers to utilize risk levels on customer accounts should therefore bring them within the reach of Regulation Best Interest, regardless of whether they are making specific transaction recommendations.

In addition to a more explicit account approval process and risk levels, FINRA or the SEC should implement a required educational course that retail investors within certain risk levels must complete before they are allowed to access options, futures, or margin trading. Ideally, the successful completion of the educational course would be utilized to move an investor to a lower risk level. As Robinhood critics have argued, retail investors "need knowledge as much or more than they need a streamlined trading experience."[196] Providing retail investors with education and training before they obtain access to these products would increase the chance that they make more informed decisions before executing trades. The goal of this educational component should be to highlight the risks inherent in these products and to encourage retail investors to keep their complete financial picture and risk tolerance in mind when trading options, futures, or on margin. In keeping with the ease of access model that broker-dealers have embraced over the past few years, these courses could be offered through the online or app interfaces that retail investors currently utilize. FINRA or the SEC should build these courses themselves with the same goal of retail investor protection in mind. They should also require broker-dealers to keep each account's results and certification of completion on file. Enforcing protective measures such as these may not ensure total protection of retail investors, but they would compel broker-dealers to assume more of this responsibility – the same responsibility the members of Congress who wrote the letter to Robinhood were concerned about.

CONCLUSION

The growing popularity of online broker-dealers does not appear to be slowing anytime soon. Retail investors are finding the stock market more accessible than ever before, and therefore, they have easier access to greater

195. *See* Letter from David Dusseault to Brad Sherman et. al., *supra* note 27.
196. *See* Chen, *supra* note 24.

wealth creation. This, in turn, benefits the companies they are investing in and the economy as a whole. However, without proper protections in place, dangers can arise for retail investors given their limited market knowledge and experience. Their unchecked exuberance, when combined with Robinhood's ease of access to complex trading products, can lead to illogical and sometimes dangerous outcomes. In order to appropriately encourage stock market accessibility in a safe manner, the SEC and FINRA need to require more from broker-dealers like Robinhood. Specifically, they need to provide more explicit guidelines and procedures surrounding the eligibility requirements which allow retail investors to access certain complex and high-risk trading products. In addition to making the account approval process more straightforward, educational programs, similar to the financial literacy programs required in the student loan and mortgage industries, should be implemented before retail investors in certain risk levels can obtain access to options, futures, and margin trading.

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