

**Congress of the United States**  
**Washington, DC 20515**

September 18, 2020

The Honorable Jay Clayton  
Chairman  
US Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Mr. Robert W. Cook  
President and Chief Executive Officer  
The Financial Industry Regulatory Authority, Inc.  
1735 K Street, NW  
Washington, DC 20006

**Re: Regulatory Oversight of Online Trading Platforms**

Dear Chair Clayton and Mr. Cook:

We write to inquire what actions the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority, Inc. (FINRA) are taking to protect inexperienced investors who are often the marketing targets of online trading platforms. Once successfully targeted, many online investment platforms allow novice investors to quickly engage in risky short-term trading, trade complex financial instruments, and/or to trade on margin. Included in the SEC's and FINRA's missions is a commitment to protecting investors. We urge both regulators to take steps to keep that promise by protecting these particularly vulnerable investors.

As you are aware, on June 12, 2020, Naperville, IL native Alexander Kearns committed suicide after Robinhood, a popular online trading platform, reportedly displayed that Mr. Kearns's account had a negative cash balance of \$730,000.<sup>1</sup> Mr. Kearns attempted to reach out to Robinhood, but he was only able to reach an auto-attendant that did not help him remedy the situation or understand the cash balance. It appears that Mr. Kearns did not actually owe anywhere

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<sup>1</sup> See Apparent suicide by 20-year-old Robinhood trader who saw a negative \$730,000 balance prompts app to make changes, CNN Business, June 20, 2020, available at <https://www.cnn.com/2020/06/19/business/robinhood-suicide-alex-kearns/index.html>

close to \$730,000.<sup>2</sup> Instead it was simply that part of his multi-leg options trades had not yet settled.<sup>3</sup> This is something an experienced options trader would know. Mr. Kearns, who was just 20-years old at the time, was not an experienced options trader. He was a young student, home from college. Mr. Kearns's death is not only tragic and senseless, but it sheds light on the regulatory issues stemming from online trading platforms and their real-world impacts.

Put simply, we worry that online trading platforms are not appropriately disclosing risks or providing reasonable safeguards for their users.

### Potentially Misleading Advertising and Murky Conflicts of Interest

As of May 2020, Robinhood had 13 million account holders.<sup>4</sup> The average age of Robinhood investors is 31 and half of Robinhood's investors have never previously invested.<sup>5</sup> During the COVID-19 pandemic, online trading platforms, such as Robinhood, experienced a surge of investors looking to take advantage of COVID-19 market volatility. Robinhood's business model is based on payments for order flow, which appears to incentivize it to encourage customers to engage in risky, frequent, short-term trading activity rather than adopting longer term investment strategies.<sup>6</sup> Attracted to these types of platforms by promises of commission-free trading, traders may not fully appreciate the conflicts of interest and hidden costs that derive from this business model.

### Making Investing a Video Game

As part of its marketing strategy and its mission to “democratize finance for all,”<sup>7</sup> the Robinhood app has the distinct feeling of a game. When investors sign-up they are prompted to “claim your free stock” which allows them to pick from one of three mystery options. Once they have picked, investors must “scrub” to reveal the stock in the same manner as a scratch off lottery ticket. After revealing the stock, the investor is greeted with a “Congratulations” message and confetti and the option to earn more free stock for inviting friends to the app. It is these platform design elements that make investing on the platform resemble a game, potentially influencing users

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<sup>2</sup> See id.

<sup>3</sup> See id.

<sup>4</sup> See Robinhood Has Lured Young Traders, Sometimes With Devastating Results, New York Times, available at <https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html>.

<sup>5</sup> See Robinhood has lured young traders, sometimes with devastating results, The Economic Times, July 20, 2020, available at [https://economictimes.indiatimes.com/markets/stocks/news/robinhood-has-lured-young-traders-sometimes-with-devastating-results/articleshow/77237308.cms?utm\\_source=contentofinterest&utm\\_medium=text&utm\\_campaign=cppst](https://economictimes.indiatimes.com/markets/stocks/news/robinhood-has-lured-young-traders-sometimes-with-devastating-results/articleshow/77237308.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst).

<sup>6</sup> Fees from payment for order flow are not unique to Robinhood and are an increasing revenue stream for many retail brokerages that have moved to zero commission trading. Robinhood does, however, receive more fees from payment for order flow relative to its competitors, and also receives higher rates per share for this order flow. See <https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html>

<sup>7</sup> See Robinhood website, as of July 31, 2020, available at <https://robinhood.com/us/en/support/articles/our-mission/#:~:text=Robinhood's%20mission%20is%20to%20democratize,for%20newcomers%20and%20experts%20alike>.

away from taking informed, calculated risks.<sup>8</sup> These types of design choices have been described as “dark patterns”, that is, user interface elements intentionally crafted to steer users to take a desired action that they might not otherwise take.<sup>9</sup>

With their business model based on frequent trading activity, many online trading platforms are created with the intention of influencing customer behavior. Robinhood, for example, has advertised a job posting for a “Behavioral Insights Researcher” whose job qualifications includes the ability “to infuse products with behavioral insights” and having a “strong command of quantitative methods – especially experiment design (on and off-platform), data analysis, and causal inference.”<sup>10</sup>

### Enabling Risky Investment Behavior

More broadly, as Robinhood and other online trading platforms have acquired users amidst the pandemic, we are concerned by the increasingly risky behavior that these investors have exhibited, and the significant capital markets distortions it can raise. One widely reported example involves Hertz, the rental car company. The company’s stock, which had been trading at over \$20/share in February prior to the pandemic, plummeted to \$0.56/share following its May 22<sup>nd</sup> bankruptcy filing, before rebounding by almost 900% in mid-June.<sup>11</sup> Much of this increased demand appears to have come from retail investors and because a bankrupt company like Hertz will typically not have sufficient funds to satisfy its creditors--who are first in line to get repaid following a bankruptcy-- outstanding shares held by these retail investors will likely be worthless.<sup>12</sup> For example, immediately prior to Hertz’s bankruptcy filing, only about 43,000 Robinhood accounts owned shares of Hertz; that number jumped to nearly 171,000 by mid-June,

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<sup>8</sup> See Does Robinhood Make It Too Easy to Trade? From Free Stocks to Confetti, The Wall Street Journal, available at <https://www.wsj.com/articles/confetti-free-stocks-does-robinhoods-design-make-trading-too-easy-11597915801>.

<sup>9</sup> See Does Robinhood Make It Too Easy to Trade? From Free Stocks to Confetti, The Wall Street Journal, available at <https://www.wsj.com/articles/confetti-free-stocks-does-robinhoods-design-make-trading-too-easy-11597915801> (describing, *inter alia*, design choices that make it easier to move forward with a trade on the Robinhood app than to cancel one). See also, Designed To Distract: Stock App Robinhood Nudges Users To Take Risks, NBC News, available at <https://www.nbcnews.com/tech/tech-news/confetti-push-notifications-stock-app-robinhood-nudges-investors-toward-risk-n1053071>

<sup>10</sup> See job posting on Startup.jobs.com, as of July 31, 2020, available at <https://startup.jobs/behavioral-insights-researcher-at-robinhoodapp> (noting, the job is no longer available).

<sup>11</sup> See Robinhood & Hertz: The Troubling Saga Of A Bankrupt Stock, Forbes, available at <https://www.forbes.com/advisor/investing/robinhood-bankrupt-hertz/>.

<sup>12</sup> As of June 10<sup>th</sup>, Hertz’s unsecured bonds were trading at 40 cents on the dollar, a severe discount that underscored creditors’ belief that Hertz could not repay all of its obligations. See “This Is Just F--king Unbelievable!”: Bankrupt Hertz Is a Pandemic Zombie, Vanity Fair, available at <https://www.vanityfair.com/news/2020/06/bankrupt-hertz-is-a-pandemic-zombie>. See also <https://www.sec.gov/reportspubs/investor-publications/investorpubsbankrupthtm.html> (“Investors should be cautious when buying common stock of companies in Chapter 11 bankruptcy. It is extremely risky and is likely to lead to financial loss. Although a company may emerge from bankruptcy as a viable entity, generally, the creditors and the bondholders become the new owners of the shares. In most instances, the company’s plan of reorganization will cancel the existing equity shares. This happens in bankruptcy cases because secured and unsecured creditors are paid from the company’s assets before common stockholders. And in situations where shareholders do participate in the plan, their shares are usually subject to substantial dilution.”).

according to RobinTrack.<sup>13</sup> Until very recently, Robinhood displayed for its users stocks that were popular among other Robinhood traders, a feature which has been attributed to driving the herd mentality in trading patterns.<sup>14</sup> eToro, another platform that has 14 million users, gives investors the option to copy trades made by other people and if enough people copy the trade they can receive 2% of what the copying earned.<sup>15</sup> These are just some examples of momentum-based “herd” trading by users of online trading platforms. While speculative trading bets by retail investors are not a new phenomenon, online trading platforms today operate in a manner that seem to amplify such trends and raise questions about whether the existing framework of risk disclosures and investor protections are adequate. It also raises questions of whether these episodes create problematic market distortions, the consequences of which are disproportionately borne by retail investors least equipped to manage them.

### Questions

It is concerning that any financial institution would entice investors with misleading advertisements, a game-like design, and then allow these investors to trade complex financial instruments and trade with borrowed money without first having appropriate precautions in place. It is critical the SEC and FINRA respond to this conduct and ensure that proper regulatory guardrails are in place that cover emerging technology-enabled activities and practices that may not have been deployed even a few years ago. Toward that end, we ask:<sup>16</sup>

1. How is the SEC/FINRA overseeing online trading platforms’ marketing and advertising activities, including platform activities (whether through websites or mobile apps) that are designed to influence investor behavior, such as in-app invitations to apply for options trading approval?
2. Is the SEC/FINRA evaluating how investing and trading patterns are influenced by platform design?
  - a. If so, how has the SEC/FINRA evaluated how these platforms influence investor behavior?
  - b. If so, what methods and measures is the SEC/FINRA using to evaluate these patterns?
3. Is the SEC/FINRA evaluating whether online trading platforms meet the minimum regulatory criteria for customers to be approved for investment in complex instruments or

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<sup>13</sup> Robinhood previously made publicly available anonymized data on its users’ shareholdings, including how many users own a specific stock, which were published and tracked by third-party sites such as Robintrack.net.

<sup>14</sup> See Money Stuff: Robinhood Ends Its Popularity Contest, available at <https://www.bloomberg.com/news/newsletters/2020-08-10/money-stuff-robinhood-ends-its-popularity-contest?sref=Z0rRhJZL>

<sup>15</sup> See Does Robinhood Make It Too Easy to Trade? From Free Stocks to Confetti, available at <https://www.wsj.com/articles/confetti-free-stocks-does-robinhoods-design-make-trading-too-easy-11597915801>

<sup>16</sup> For purposes of these questions, please assume that references to online trading platforms refer to those platforms that are broker-dealers duly registered with the SEC and FINRA. In addition, if your response to these questions differs depending on whether it involves a directed or non-directed account, please so indicate this in your response.

trading on margin and, if so, is the SEC/FINRA evaluating whether that criteria is sufficient?

4. More specifically, how does FINRA evaluate broker-dealers' compliance with FINRA Rule 2360(b)(16), which requires broker-dealers to "exercise due diligence to ascertain the essential facts relative to the customer, his financial situation and investment objectives" in approving a customer's account for options trading? Does FINRA review the specific rules, formulas, or algorithms that a broker-dealer may employ in order to determine whether a customer meets its due diligence requirements?<sup>17</sup>
5. Will FINRA commit to ensuring that FINRA Rule 2360 ("Options"), and in particular, FINRA Rule 2360(b)(16) ("Diligence in Opening Accounts") will be a risk monitoring, surveillance, and examination priority for its 2021 examination cycle?
6. Has the SEC or FINRA evaluated investor trading behavior across different platforms that also offer commission-free trading?
  - a. If so, have those differences in trading behaviors impacted portfolio performance?
7. On June 25, 2020, Chair Clayton testified before the House Financial Services Committee that "Disclosure is only good if people can understand it." Is the SEC/FINRA ensuring the disclosure documents that are intended to inform investors are achieving their intended purpose with online platforms? Has any investor testing been conducted on disclosure documents on online trading platforms?
8. Has the SEC/FINRA evaluated the relative effectiveness of disclosure documents as compared to elements of platform design on investor behavior?
9. How has the SEC/FINRA ensured that platform elements like advertising free stock, push notifications, etc. are not adversely or improperly influencing the investor's investment decisions?
10. In light of the increasing importance of payment for order flow to retail brokerages, and the conflicts of interest it may create for these firms, what steps is the SEC/FINRA taking to ensure that the investor is receiving the best execution of its orders, including under FINRA Rule 5310, which requires firms to use reasonable diligence to find the best market for a security and buy or sell in such market so that the customer receives a price that is as favorable as possible under prevailing market conditions?

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<sup>17</sup> We are aware that pursuant to FINRA Rule 2360(b)(16), broker-dealers must seek to obtain a minimum amount of information from its customers regarding investment objectives, employment status, estimated annual income from all sources, estimated net worth, estimated liquid net worth, marital status, number of dependents, age, and investment experience and knowledge. We are seeking information on the depth and quality of information a broker-dealer must collect beyond the standard self-certified multiple-choice questions that are commonly found in account opening applications, and how question design influences the responses in the applications. We are also seeking to understand the extent to which regulators evaluate how broker-dealers analyze this collected information in approving accounts for options trading at various levels.

We appreciate your prompt attention to these important matters and ask that you please respond in writing no later than October 2, 2020.

Sincerely,



SEAN CASTEN  
Member of Congress



BRAD SHERMAN  
Chairman  
Subcommittee on Investor Protection,  
Entrepreneurship and Capital Markets



BILL FOSTER  
Chairman  
Task Force on Artificial Intelligence



GREGORY W. MEEKS  
Chairman  
Subcommittee on Consumer Protection and  
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DAVID SCOTT  
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