June 24, 2022

M E M O R A N D U M

TO: Republican Members, House Committee on Financial Services

FROM: Republican Staff

RE: The Chairwoman's Staff Report on the January 2021 Meme Stock Event

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Executive Summary

Today, the Chairwoman issued a staff report on the Committee's 17-month investigation of the "meme stock" event of January 2021. The findings and recommendations contained therein tend to be at odds with documents and testimony obtained by the Committee that show the core infrastructure of the securities market remained resilient despite the extraordinary volatility related to meme stocks during the event. This memorandum supplements the Chairwoman's report and corrects the record as necessary.

The evidence shows retail investors are participating in the securities market at record levels, and new market participants tend to be younger and more diverse with comparatively lower income and household wealth than the industry as a whole. Those trends correlate with the prevalence of modern brokerage features such as zero commission trading and the ability to buy fractional shares, among other things.

During the meme stock event, many first-time investors opened accounts at Robinhood Financial LLC (Robinhood), where the median account size was less than $240, and the average account size was about $5,000 during January 2021. Robinhood, like most other zero commission brokerages, relies on payment for order flow (PFOF) for revenue. PFOF refers to payments that brokerages receive for directing customer trades to a market maker. Those companies are required to give customers the best price, known as "best execution."

Rather than embrace innovations that made investing more accessible, Democrats are leveraging public outrage about trading restrictions imposed by several brokerages during the meme stock event to push policies that make investing more expensive and less accessible for everyday investors. In fact, the effort to sow doubt about PFOF started well before the meme stock event and increased immediately, when Democrats alleged without evidence that a market maker colluded with Robinhood to protect its bottom line.

The facts show they were wrong—there is no evidence of any collusion between market makers and broker-dealers, as the Chairwoman's own report makes clear. But the Securities and Exchange Commission (SEC) is attempting to use the cloud of uncertainty about PFOF that Democrats helped create in the wake of the meme stock event to justify banning the practice.

Republicans should continue to ensure any proposals to reform the relationship between investors and their brokerages are evidence-based and intended to preserve the dynamics that democratized the retail marketplace in the first place.

Background

Beginning in 2019, retail investors who used online forums such as Reddit's WallStreetBets began touting the upside of GameStop, a brick-and-mortar video game company struggling with lower game and console sales and a decline in profits. Perhaps more importantly, investors noticed an extraordinarily high ratio of short positions on GameStop compared to the total number of shares outstanding. Retail investors recognized that the conditions were ripe for a "short squeeze"—a sophisticated trading strategy to drive up the price of a stock and force short sellers to cover their positions or face increasingly heavy losses.

In December 2020, the share price for GameStop (GME) stock averaged about $17.[1] At that time, retail investors with varying levels of experience used WallStreetBets to plan and execute a short squeeze against professional investors who were over-exposed to rising GME prices. In just three days, from January 25 to January 28, 2021, the price of GameStop shares rose over 530 percent to an all-time high of $483. The same investor communities recognized similar opportunities for a short squeeze in several other stocks, including AMC Entertainment Holdings Inc. (AMC).

But an opaque and outdated system for settling trades forced several of the brokerages favored by online retail investors to briefly restrict trading in GME, AMC, and several other "meme stocks." In particular, Robinhood's decision to move to position closing only (PCO) status for the meme stocks created a market without buyers, and share prices fell accordingly. Customers who owned GME and other restricted symbols during the period in question were left holding the bag.

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In 2021, more than ten million new customers opened Robinhood accounts,[2] and by the end of the year, there were approximately 35,925,000 open accounts at the brokerage.[3] Compared to the overall retail investor class, new Robinhood customers were more likely to be young and diverse. They were also more likely to be first time investors. New Robinhood

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[1] Saqib Iqbal Ahmed, April Joyner, *Bearish GameStop options contracts fly off the shelf after stock surge*, Reuters (Jan. 28, 2021), *available at* https://www.reuters.com/article/us-GameStop-stocks-options/bearish-GameStop-options-contracts-fly-off-the-shelf-after-stock-surge-idUSKBN29X0LE.

[2] Robinhood Press Release, "Robinhood Reports Fourth Quarter and Full Year 2021 Results," Jan. 27, 2022, https://investors.robinhood.com/news/news-details/2022/Robinhood-Reports-Fourth-Quarter-and-Full-Year-2021-Results/default.aspx.

[3] Letter from Reginald J. Brown, P.C., to Hon. Maxine Waters, Chairwoman, H. Comm on Fin. Services, and Hon. Al Green, Chairman, Subcomm. On Oversight and Investigations (Feb. 15, 2022).

customers could open an account, make a deposit, and buy stock in a matter of minutes, without paying a fee, and many of those customers purchased GME and other meme stocks in January 2021.

A new Robinhood customer would immediately have access to deposits, and could begin to trade using up to $1,000 of that money right away, even though the deposited funds would not clear for several days.[4] Moreover, customers own the shares they purchase through Robinhood upon order execution, even though an order does not settle until two days later.[5] This is made possible by the hidden plumbing of the investment industry, which effectively allows investors to participate in the market even while the actual transfer of ownership of an asset is being settled.

The settlement process requires brokerages like Robinhood to post collateral on a daily basis as trades clear. At approximately 5:11 AM EST on January 28, 2021, as the meme stock event approached its crescendo, Robinhood Securities received an automated notice stating it had a deposit deficit of approximately $3 billion.[6] Hours later, Robinhood issued a statement on the company's blog. The statement, addressed to the company's customers, said in part: "In light of recent volatility, we restricted transactions for certain securities to position closing only."[7] The restricted ticker symbols included GME, AMC, and several other highly volatile meme stocks.[8] Several other brokerages imposed similar trading restrictions during the period in question.

GameStop closed at $193.60 per share on January 28, 2021, down 44.3 percent from a day earlier. Robinhood's decision to restrict trading immediately became the subject of an array of investigations and litigation.

<u>Overview of the Committee's Investigation</u>

For 17 months, the Committee investigated the extreme volatility in the stock market in late January 2021, with an emphasis on the actions of Robinhood and Citadel. In addition to three public hearings, Committee staff interviewed more than 50 fact and expert witnesses, including officials from Robinhood, Charles Schwab, Citigroup, Citadel, Depository Trust and Clearing Corporation (DTCC), National Securities Clearing Corporation (NSCC), New York Stock Exchange (NYSE), and Financial Industry Regulatory Authority (FINRA). The Committee also obtained more than 90,000 pages of documents from those entities, and others.

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[4] *See* Robinhood Accounts, https://robinhood.com/us/en/support/articles/robinhood-accounts/.
[5] *See* Answers to Top Questions, https://robinhood.com/us/en/support/articles/Answers-to-top-questions/ ("You own the shares you buy through Robinhood as soon as your order is executed.")
[6] RH_HFSC_00001054. (on file with Committee)
[7] Robinhood blog, "Keeping Customers Informed Through Market Volatility" (Jan. 28, 2021), https://blog.robinhood.com/news/2021/1/28/keeping-customers-informed-through-market-volatility.
[8] *Id.*

The documents and testimony show the unprecedented nature of the meme stock event, the factors that exposed some firms to significant losses, the actions that certain firms took to mitigate risk and potential harm to consumers, and how the regulatory framework performed.

Despite the absence of evidence, Democrats in Congress and at the SEC saw an opportunity to leverage the aggrievement of Robinhood's customers to justify a more restrictive trading environment for retail traders. Some embraced a conspiracy theory that linked Robinhood's decision to restrict trading to the company's relationship with Citadel, a market maker that purchases order flow from Robinhood.

The facts show they were wrong—there is no evidence of collusion between market makers and broker-dealers, and there is no basis to prohibit payment for order flow. But their allegations created an atmosphere of uncertainty with respect to a connection between PFOF and the market events of January 2021, which appears to have been sufficient to provide cover for the SEC to abandon its long-standing position that the practice "benefits small investors."[9] In fact, PFOF has been accepted and regulated by the SEC for decades—it featured prominently in Rule 11Ac1-6, which became Rule 606 (2000), the Concept Release on Equity Market Structure (2010), and amended Regulation NMS Rule 606 (2018).[10]

Despite the lack of evidence for prohibiting PFOF, on June 8, 2022, SEC Chairman Gary Gensler outlined a proposal to change U.S. stock-trading rules to that effect. In a speech at a conference, he expressed concerns that "payment for order flow may incentivize broker-dealers to use digital engagement practices, such as gamification, to increase customer trading"[11] and he directed SEC staff to "make recommendations around how [to] mitigate conflicts with respect to payment for order flow and rebates."[12]

Against that backdrop, the Chairwoman's report raises questions as to Robinhood's business model (which features zero commission trades and relies on PFOF for revenue). In fact, there is no evidence of any connection between PFOF and the events of January 28, 2021. The references in the Chairwoman's report to Robinhood's reliance on PFOF therefore appear intended to bolster Chair Gensler's rulemaking agenda.

The Chairwoman's report further states that Robinhood was "unprepared[] to meet its regulatory capital obligations;" had "difficulty in meeting its NSCC collateral requirements;" "faced operational and liquidity concerns all week;" and did not have a "sufficient capital

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[9] Thomas Franck, *GOP Senator Toomey debuts bill to protect broker revenues, payment for order flow*, CNBC, Oct. 28, 2021, https://www.cnbc.com/2021/10/28/gop-senator-toomey-debuts-bill-to-protect-payment-for-order-flow.html.

[10] *See* 17 C.F.R. § 242.606.

[11] Remarks of Hon. Gary Gensler, Chairman, SEC before the Piper Sandler Global Exchange Conference (June 8, 2022), *available at* https://www.sec.gov/news/speech/gensler-remarks-piper-sandler-global-exchange-conference-060822.

[12] *Id*.

cushion."[13] But the documents and testimony show Robinhood met its capital requirements pursuant to SEC regulations and its NSCC collateral requirement on January 28, 2021, and on every other day, In fact, Robinhood had a collateral deposit surplus of more than $1 billion on January 29, 2021.[14]

Correcting the Record

Before the Committee obtained a shred of evidence, Democrats rushed to amplify conspiracy theories that connected Citadel payments for order flow to Robinhood's decision to impose trading restrictions on several meme stocks. Now, after the Committee's 17-month investigation, statements from high-profile Democrats in Congress have been shown to have no basis in the evidence.

1. Democrats alleged collusion between Citadel and Robinhood. They were wrong.

Democrats on the Committee used the PFOF relationship between Citadel and Robinhood to allege the firms colluded to protect their mutual interests. For example, on January 31, 2021, the Chairwoman told MSNBC, "I am concerned about whether or not Robinhood restricted the trading because there was collusion between Robinhood and some of the hedge funds that were involved with this."[15] Before the investigation started, a spokesperson for Rep. Alexandria Ocasio-Cortez stated that the congresswoman believes "Citadel's role needs to be examined."[16]

There is no evidence Citadel influenced Robinhood's decision to impose trading restrictions on meme stocks. In fact, the decision to restrict trades occurred without any consultation between Citadel and Robinhood whatsoever, and Citadel learned about the trade restrictions via social media.

The documents show Robinhood, unlike most other broker dealers, calculated PFOF fees based on a spread-based methodology. During the week of January 25, 2021, the increased volume and volatility in certain stocks led to extremely wide spreads, which caused Robinhood's PFOF charges to all its market makers, including Citadel, to rise to exorbitant levels.

To address the PFOF charges, on the afternoon of January 27, a Citadel employee reached out to Robinhood Securities' President and Chief Operating Officer Jim Swartwout to

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[13] H. Comm. on Financial Services Majority Staff Report: "Game Stopped: How the Meme Stock Market Event Exposed Troubling Business Practices, Inadequate Risk Management, and the Need for Legislative and Regulatory Reform," 117th Cong. (June 24, 2022)

[14] RH_HFSC_00000866. (on file with Committee)

[15] Zachary Warmbrodt, *Robinhood CEO expected to testify before Maxine Waters' panel on GameStop*, POLITICO, Feb. 1, 2021, https://www.politico.com/news/2021/02/01/robinhood-ceo-testify-maxine-waters-464491.

[16] Douglas MacMillan and Yeganeh Torbati, *Robinhood and Citadel's relationship comes into focus as Washington vows to examine stock-market moves*, WASH. POST, Jan. 29, 2021.

request a call.[17] Internal communications between and among Robinhood employees show the company recognized the dramatic increase in PFOF charges required some form of mitigation. In similar circumstances, when volume and price volatility drove PFOF charges to uneconomical levels, Robinhood had agreed to adjust its rate structures.

A call was scheduled for 7:00 PM CT on January 27, 2021, with the calendar invite subject "Citadel – pfof."[18] Prior to the scheduled call, however, Robinhood proposed to cap PFOF fees on GME trades for all its market makers, including Citadel, Morgan Stanley & Co., G1 Execution Services, Wolverine Execution Services, Two Sigma Securities, and Virtu. Documents show Robinhood sent emails to each of those market makers at about 6:00 PM CT on January 27, 2021, with the same message for each: that Robinhood capped PFOF fees for GameStop at $0.003 per share retroactively to Monday, January 25, 2021.[19]

The call scheduled for 7:00 PM CT proceeded as scheduled. But as of that time, the lone Citadel employee on the receiving end of Robinhood's email had not reviewed the message and the offer to cap PFOF fees therein. Because no one at Citadel was aware of Robinhood's proposal, Citadel suggested on the call that Robinhood should consider capping PFOF fees. Citadel's posture created confusion and led Robinhood to believe that Citadel was rejecting Robinhood's proposal. Witnesses told the Committee there was no discussion about restricting or limiting trading of GameStop or any other stocks during that call, or at any other time.

Robinhood Securities COO, Jim Swartwout, who was on the 7:00 PM CT call, subsequently wrote in an internal Robinhood chat: "you wouldn't believe the convo we had with Citadel. total mess."[20]

Witnesses stated that around 8:00 PM CT, Robinhood Market Inc.'s Chief Legal Officer, Dan Gallagher, spoke by phone with Citadel's Head of Execution Services. Both parties realized Robinhood's proposal to cap PFOF fees circa 6:00 PM CT was never reviewed and the participants during the 7:00 PM CT call were accordingly befuddled. The matter was quickly resolved, and Citadel accepted Robinhood's proposal to cap PFOF fees later the night of January 27. Indeed, the Chairwoman's report acknowledges "the Robinhood team determined that they would need to impose PCO restrictions on certain volatile securities" early the next morning, after receiving the $3 billion collateral requirement from NSCC.[21]

2. *Democrats alleged retail investors are "dumb money" and "rubes" that need protection from professionals on Wall Street. They were wrong.*

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[17] CITMDL0000840. (on file with Committee)
[18] CITMDL0000533. (on file with Committee)
[19] *See, e.g.* CITMDL0000527. (on file with Committee)
[20] RHMDL00005817. (on file with Committee)
[21] H. Comm. on Financial Services Majority Staff Report: "Game Stopped: How the Meme Stock Market Event Exposed Troubling Business Practices, Inadequate Risk Management, and the Need for Legislative and Regulatory Reform," 117th Cong. (June 24, 2022) at 57.

In the wake of the meme stock event, Democrats speculated that hedge funds and market makers took advantage of retail traders and undermined the market for meme stocks to protect themselves. For instance, Rep. Jim Himes (D-CT) stated: "The retail investor is known as dumb money and there are any number of structures that are set up to take advantage of the retail investor."[22] Similarly, Rep. Bill Foster (D-IL) said, "It's very easy to make payment for order flow sound really creepy. You're basically selling a list of rubes to the sharks."[23]

In fact, hedge funds with short positions on GameStop during the period in question were devastated by the rising price in meme stocks. The SEC found the price and volume movements in GME coincided with substantial interest expressed in certain online forums devoted to retail investing, including YouTube channels and WallStreetBets.[24] SEC Chairman Gary Gensler defended those conversations as free speech. On May 6, 2021, he testified to the Committee: "[W]e all have a free speech right to go and say to a neighbor, whether it's online or in person, I like this investment."[25]

The evidence shows retail investors on WallStreetBets and elsewhere held their own against professional investors at hedge funds. Hedge funds, including Melvin Capital and Citron Capital, that shorted GameStop lost about $19 billion in January 2021.[26] In May 2022, Melvin Capital began the process of liquidating the fund's assets and returning cash to investors.[27] Melvin started 2021 with more than $12 billion but lost 53 percent of its value in January 2021, and never recovered.[28]

3. *Democrats alleged that hedge funds applied pressure on Robinhood to restrict trading in meme stocks. They were wrong.*

On January 28, 2021, within hours of Robinhood's decision to impose position-closing only restrictions on GME and other meme stock symbols, Rep. Ro Khanna (D-CA) stated, "We're done letting hedge fund billionaires treat the stock market like their personal playground,

[22] Statement of Hon. Jim Himes, *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, Hearing Before the H. Comm. on Financial Services, 117th Cong, (Feb. 18, 2021).
[23] *Id.*, statement of Hon. Bill Foster.
[24] SEC Staff Report on Equity and Options Market Structure Conditions in Early 2021, Oct. 14, 2021, at 17, *available at* https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf.
[25] Statement of Hon. Gary Gensler, Chairman, SEC, *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide Part III*, Hearing Before the H. Comm. on Financial Services, 117th Cong, (May 6, 2021).
[26] Harry Robertson, *Short-sellers are nursing losses of $19 billion*, BUS. INSIDER, Jan. 30, 2021, https://markets.businessinsider.com/news/stocks/short-sellers-sitting-on-19-billion-of-losses-on-gamestop-data-shows-2021-1-1030020684#.
[27] Matthew Goldstein and Kate Kelly, *Melvin Capital, hedge fund torpedoed by the GameStop frenzy, is shutting down,* N.Y. TIMES, May 18, 2022, https://www.nytimes.com/2022/05/18/business/melvin-capital-gamestop-short.html.
[28] *Id.*

then taking their ball home as soon as they lose. . . . We need more regulation and equality in the markets."[29] Rep. Khanna's statement created the appearance that hedge fund managers were able to convince brokerages to put a stop to the steep losses described above.

In fact, as Robinhood executives testified under oath, the brokerage imposed trading restrictions in response to a $3 billion daily collateral deficit that Robinhood received from its clearing agency, the NSCC, in the early morning hours of January 28, 2021, and not from pressure from any market participant.[30] The documents show the January 28, 2021 collateral requirement was the basis for the move to PCO on various meme stocks.

For instance, an internal Robinhood chatroom message from the morning of January 28, 2021 stated: "We have received a 3B margin call from NSCC,"[31] and another internal Robinhood chatroom message from Robinhood Securities COO Jim Swartwout later that morning stated: "we need to PCO the following symbols ASAP. At minimum: AMC, GME, NOK, BB, NAKD, KOSS, EXPR, BBBY."[32] In response, a Robinhood employee asks, "Out of curiosity what changed?" and Swartwout replied: "we received a larger than expected call – very confidentially."[33]

The SEC also rejected Rep. Khanna's theory. On October 14, 2021, the SEC released a report that reviewed the causes of the January 2021 trading restrictions, among other things. The report noted "[o]ne narrative" that "attributed the broker-dealer trading restrictions to pressure from hedge funds and their commercial partners," and concluded: "A number of clearing brokers experienced intraday margin calls from a clearinghouse. In reaction, some broker-dealers decided to restrict trading in a limited number of individual stocks in a way that some investors may not have anticipated."[34]

Conclusion

Witnesses who testified to the Committee largely agreed that what happened the week of January 25, 2021 was a Black Swan event. To cope with the event, the NSCC and its members scrambled, particularly on the morning of January 28, 2021, to stabilize their operations and preserve or achieve sufficient levels of liquidity. But those firms are now on notice—they must be prepared for social media-driven periods of extreme volatility that were outside the boundaries of predictability before that week.

[29] Press Release, "Rep. Khanna on GameStop Trades" (Jan. 28, 2021), https://khanna.house.gov/media/press-releases/statement-rep-khanna-gamestop-trades.
[30] *See, e.g.*, Written Testimony of Vlad Tenev, *Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide*, Hearing Before the H. Comm. on Financial Services, 117th Cong, (Feb. 18, 2021), tr. at 9.
[31] RHMDL00014718. (on file with Committee)
[32] RHMDL00005724. (on file with Committee)
[33] *Id.*
[34] SEC Staff Report on Equity and Options Market Structure Conditions in Early 2021, Oct. 14, 2021, at 32-33, 43-44, *available at* https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-early-2021.pdf.

As the Chairwoman's report notes, regulatory guidance for brokerages was lacking, and as a result, they had to react in real-time to an unprecedented situation. The companies took substantially similar actions: several firms imposed trading restrictions on volatile meme stocks to reduce overall risk. The NSCC also waived Excess Capital Premium charges for all members to reduce systemic risk, which reflected the fact that those charges bore no relationship to actual settlement risk posed by Robinhood Securities and other members at the time. Their collective response to the significant price and volume volatility related to meme stocks was key to the resilience of the core market infrastructure during the period in question. That fact is of little comfort for investors who were stuck holding restricted stocks on January 28, 2021, and it indicates reforms to the regulatory ecosystem should be narrowly tailored to protect that class, as opposed to large market structure changes.

Indeed, the documents and testimony obtained by the Committee since January 2021 show the antiquated system that facilitates the securities marketplace should be modernized to better serve the growing number of retail investors. Moreover, conditions in the current marketplace are such that retail traders are participating at record levels, especially young and diverse investors with lower income and household wealth. Any proposals to reform the relationship between investors and their brokerages should be evidence-based and intended to preserve the dynamics that democratized the retail investment marketplace in the first place.

Specifically, the evidence shows a shorter period for settlement of securities transactions may have prevented the need for many of the trading restrictions during the meme stock event and reduced overall risk to the securities clearing system. Congress and the SEC should expedite the effort to modernize the settlement process along those lines.