# CONSUMERS BEWARE: HOW ARE YOUR FAVORITE "FREE" INVESTMENT APPS REGULATED?

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## ABSTRACT

*The proliferation of free or low-cost investment apps has disrupted the financial industry in recent years. Major brokerage firms have been pressured to go to zero fees due to intense competition from their fintech counterparts. While these apps have extended their products and services to those underserved by traditional brokers, some of their practices raise consumer protection concerns. Namely, the practice of "payment for order flow," which helps fintech startups sustain a zero-commission model, could lead to subordinating customers' best interest to market makers who acquire their retail orders from these fintech startups. Further, "cash management accounts," newly popular among fintech startups with an ambition to compete with chartered banks raise questions about the use of idle customer assets and the protections afforded to these accounts in case of liquidation. This Note considers the products and services of these investment apps in the context of existing U.S. regulations and regulators for broker-dealers, investment advisors, and chartered banks. To illustrate this, this Note analyzes the potential consumer financial protection issues arising out of these fintech-based investment platforms' distinctive business models and the services they provide.*


## INTRODUCTION

Robinhood, Acorns, Betterment, Stash, and other free or low-cost investment apps make it easier than ever for every smartphone user to invest on the go, with zero experience and little more than pocket change. These kinds of apps are exploding right now, appealing mainly to young people because of their "low barriers to entry, automation and familiar tap-swipe-buy, Tinder-style interface."[2] For almost all of these apps, all users have to do is first download the app, then set up a profile that lets the company behind the app know the best kinds of investment suitable for the user's risk averseness and return expectations, and finally connect a bank account to give access to some funds and be done.

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[2] Jennifer Jolly, *Micro Investing Apps Have Been Popular during the Stock Market's Rise. Do They Work When It Dives?* USA TODAY (Mar. 8, 2018), https://www.usatoday.com/story/tech/columnist/2018/03/08/micro-investing-apps-have-been-popular-during-stock-markets-rise-do-they-work-when-dives/390787002/.

Fintech is defined as "technology-enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services."[3] With people now spending almost seven times longer on apps than on mobile sites and mobile use accounting for an ever-larger portion of the time people spend online, the spurt of investment apps is a logical development for the fintech industry.[4] Offering an improved user experience and greater command over different aspects of money management, investment apps are considered by many users as a practical and economical way of managing their finances. However, by targeting underserved and less sophisticated investors, these low-cost or "free" apps can also threaten less vigilant app users who previously lacked exposure to the investing world.

With so many investment apps, online exchanges, and brokerages, there are ostensibly an infinite amount of options for people to invest in everything from stocks to exchange-traded funds (ETFs) to cryptocurrency. The poster child for one of these fast-growing, low-cost (or free) online investment platforms is Robinhood. This app boasts a fee-free model that provides minimal to no cost trading for its customers.[5] "As part of its easily-accessible, trading-for-the-people model, Robinhood doesn't require an account minimum to trade, and offers commission-free trades for users," contrary to most conventional investment firms.[6] However, much like a traditional broker-dealer, Robinhood operates under a decent amount of regulation by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA).[7] The same regulators also have jurisdiction over robo-advisors, such as Betterment, a low-cost wealth management company that mostly provides its automated investing service through an app as well.[8]

The proliferation of these free or low-cost investment apps has disrupted the financial industry in recent years. Major brokerage firms have been pressured to eliminate fees. Since Robinhood offered stock trading for free in 2013,[9] Vanguard Group slashed fees on ETF trades, and

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[3] Fin. Stability Bd., *FSB Report Assesses FinTech Developments and Potential Financial Stability Implications*, (Feb. 14, 2019), https://www.fsb.org/2019/02/fsb-report-assesses-fintech-developments-and-potential-financial-stability-implications/.

[4] Maulik Sailor, *Top 5 Fintech and Banking Apps*, INNOVIFY, https://www.innovify.com/blogs/top-5-fintech-and-banking-apps (last visited Dec. 19, 2019).

[5] Anne Sraders, *Is Robinhood Safe? What to Know About the Investment App in 2019*, THESTREET (Apr. 28, 2019), https://www.thestreet.com/technology/is-robinhood-safe-14933475.

[6] *Id.*

[7] *See id.*

[8] Editorial Staff at Betterment Res. Ctr., *Your Security and Trust Come First*, BETTERMENT (Mar. 3, 2014), https://www.betterment.com/resources/investment-safety-and-security-at-betterment/ [hereinafter *Betterment Res. Ctr.*].

[9] Maggie Fitzgerald, *The End of Commissions for Trading Is Near as TD Ameritrade Cuts to Zero, Matching Schwab*, CNBC (Oct. 2, 2019),

J.P. Morgan Chase started its own free trading app.[10] In October 2019, traditional broker-dealers, the likes of Interactive Brokers, Charles Schwab, TD Ameritrade, and E*Trade announced, within less than a week of one another, that they would cut commissions to zero.[11] While Robinhood does not directly collect commissions from customer's trading activities, it does monetize through a variety of other avenues including "marginal interest and lending, premium accounts and rebates."[12] One of the more controversial channels is "payment for order flow," where online brokerages outsource the execution of their app users' orders to firms that pay for the right to handle those trades in exchange for a fee.[13] "All brokerage firms that sell order flow are required by the SEC to disclose who they sell order flow to and how much they pay."[14]

Even though all these fintech startups offered more specialized and tailored products from their inception, most of them have bigger aspirations and wish to replace conventional players in the financial industry eventually and become customers' central financial partner. SoFi, Inc., for example, has expanded its services and product lines to mortgages, life insurance, and wealth management, together with student loan refinancing, the startup's focus when it launched.[15] Robinhood, now with more than six million users, has rolled out a high-yield cash management account and ultimately wants to become a federally chartered national bank.[16] These new commercial banking products and services elicit new regulatory concerns regarding consumer protection.

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https://www.cnbc.com/2019/10/02/the-end-of-commissions-for-stock-trading-is-near-as-td-ameritrade-cuts-to-zero-matching-schwab.html.

[10] Maggie Fitzgerald, *Charles Schwab Is Ending Commissions on Stock Trading and the Brokerage Shares Are Tanking*, CNBC (Oct. 1, 2019), https://www.cnbc.com/2019/10/01/charles-schwab-is-eliminating-online-commissions-for-trading-in-us-stocks-and-etfs.html.

[11] Fitzgerald, *supra* note 9.

[12] Sraders, *supra* note 5.

[13] Simone Foxman, Julie Verhage, and Suzanne Woolley, *Robinhood Gets Almost Half Its Revenue in Controversial Bargain with High-Speed Traders*, BLOOMBERG (Oct. 15, 2018), https://www.bloomberg.com/news/articles/2018-10-15/robinhood-gets-almost-half-its-revenue-in-controversial-bargain-with-high-speed-traders.

[14] Logan Kane, *Robinhood Is Making Millions Selling out Their Millennial Customers to High-Frequency Traders*, (Sep. 10, 2018), SEEKING ALPHA, https://seekingalpha.com/article/4205379-robinhood-is-making-millions-selling-out-millennial-customers-to-high-frequency-traders.

[15] Ainsley Harris, *Robo-Advisor Betterment Is on A Personalization Push as It Surpasses $10 Billion in AUM*, FAST COMPANY (Jul. 31, 2017), https://www.fastcompany.com/40442080/robo-advisor-betterment-is-on-a-personalization-push-as-it-surpasses-10-billion-in-aum.

[16] Kate Rooney, *Robinhood Makes Second Attempt at Launching a High-yield Account Similar to Banks*, CNBC (Oct. 8, 2019), https://www.cnbc.com/2019/10/08/robinhood-makes-second-attempt-at-launching-a-high-yield-account-similar-to-banks.html.

## I. FINTECH AND THE RISE OF INVESTMENT APPS

### *A. How Fintech Start-Ups Innovated and Disrupted the Online Brokerage and Robo-Adviser Market*

The advent of fintech promises to reshape the financial industry by reducing costs, improving the quality of financial services, and creating "a more diverse, secure and stable financial services landscape."[17] "The use of digital technologies [and big data in fintech] makes it possible to provide many existing financial services more efficiently and to enhance these services."[18] S&P Global divides fintech activities into six types: payments, financial media and data solutions, banking technology, insurance technology, digital lending, and investment and capital markets technology.[19] Of the six fintech subsectors that S&P Global Market Intelligence tracks, the investment and capital markets technology subsector produced the most transactions in 2017, totaling roughly $181 billion in assets under management (AUM).[20] The AUM in the subsector is projected to be $608 billion in 2022.[21]

The move to low-fee and even no-fee models is a common theme among retail-focused apps in the investment and capital markets technology subsector. Among the field, Robinhood stands out as one of the fastest-growing investment apps since introducing its commission-free business model in 2015.[22] Meanwhile, incumbents such as Fidelity and Charles Schwab have since cut their equity and ETF commissions.[23] The free or low-cost model is considered one of the truly disruptive changes in the investment technology landscape, and its impact appears to be ongoing. For instance, JPMorgan's You Invest, launched in August 2018, offers customers 100 commission-free online stock and ETF trades.[24] Further, fintech startups like Robinhood are willing to waive commissions

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[17] Arup Kumar Chatterjee & Poornima Jayawardana, *How FinTech Can Accelerate Financial Inclusion in Indonesia*, ASIAN DEV. BLOG (Apr. 2018), https://blogs.adb.org/blog/how-fintech-can-accelerate-financial-inclusion-indonesia.

[18] Stulz, Rene M., *FinTech, BigTech, and the Future of Banks* 1. (Fisher Coll. of Bus. Working Paper No. 26312, 2019).

[19] *See* Katie Darden, Nimayi Dixit, & Tom Mason, *2018 US Fintech Market Report*, S&P Global Market Intelligence 1, 4 (2018), https://www.spglobal.com/marketintelligence/en/documents/2018-us-fintech-market-report.pdf.

[20] *See id.*

[21] *See id.*

[22] Josh Constine, *Zero-Fee Stock Trading App Robinhood Nabs $50M from NEA to Go Global*, TECHCRUNCH (May 7, 2015), https://techcrunch.com/2015/05/07/free-stock-trades/

[23] *See* Mark DeCambre, *Fidelity Cuts Fees to $0 as It Jumps on Zero-commission Bandwagon*, MARKETWATCH (Oct. 12, 2019), https://www.marketwatch.com/story/fidelity-cuts-fees-to-0-as-it-jumps-on-zero-commission-bandwagon-2019-10-10.

[24] *Meet You Invest: A New Way to Trade Online Commission-Free*, JPMORGAN CHASE & CO. (Aug. 29, 2018), https://www.jpmorganchase.com/corporate/news/pr/meet-you-invest-new-way-to-trade-online-commission-free.htm.

if they could amass a larger customer base as a result.[25] That is because, with a large pool of active users, fintech startups can still sustain themselves by tapping into several other revenue streams available to traditional brokers, including "securities lending, interest on cash held in brokerage accounts, margin lending and routing order flow to exchanges."[26]

Fintech startups in the investment and capital markets technology subsector also can differentiate themselves from their traditional counterparts with "personalized niche services, data-driven solutions, an innovative culture, and a nimble organization."[27] They have little to lose, can innovate rapidly, and do not fear mistakes. Fintech startups are also willing to accept more feedback from their users and focus on interfaces that maximize customer experience.[28] An important factor that enables fintech firms to innovate more rapidly is that the digital technologies they rely on have huge built-in economies of scale.[29] With digital technologies, the marginal cost of one more customer is generally trivial. Therefore, as long as these firms have a large enough client base to ensure that their total revenue is larger than their total cost, which doesn't increase by much as more users sign up for their products, they do not have to predicate the availability of their products on the basis that every user individually has to contribute to their revenues. That leads to one of the most significant advantages to these digital-exclusive micro-investing platforms: they can afford to let users bypass brokerage account minimums and extend their products to those underserved by traditional brokers because of the user's lack of funds.[30]

### *B. Overview of the Regulatory Framework for Online Broker-Dealers and Robo-Advisors*

Fintech firms have been provided with a favorable regulatory environment since the 2008 financial crisis. On the other hand, traditional financial institutions have been subject to more rigorous regulation, capital requirements, and reporting requirements from regulators since 2008. "The looser regulatory requirements imposed on fintech startups allow them to provide more customized, inexpensive, and easy-to-access financial services to consumers than traditional institutions."[31] The predominant revenue sources for these online broker-dealers and robo-advisors are individual customers and small and medium-sized enterprises,[32] therefore making consumer protection a focal point of the regulatory scheme around them.

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[25] *See* Darden, *supra* note 19, at 5.
[26] *Id.*
[27] In Lee & Yong Jae Shin, *Fintech: Ecosystem, Business Models, Investment Decisions, and Challenges*, 61 BUSINESS HORIZONS 35, 36 (2017).
[28] *See* Anirban Bose, Penry Price, & Vincent Bastid, *World FinTech Report 2018*, Capgemini, LinkedIn & Efma 1, 19 (2018), https://www.capgemini.com/wp-content/uploads/2018/02/world-fintech-report-wftr-2018.pdf.
[29] Stulz, *supra* note 18.
[30] *See* Jolly, *supra* note 2.
[31] *See* Lee & Shin, *supra* note 27, at 37–38.
[32] *Id.*

Fintech startups face different regulatory requirements based on the type of financial services they provide. For instance, Robinhood, as a broker-dealer, is regulated by the SEC.[33] Additionally, the app is a voluntary member of FINRA[34], a self-regulatory organization (SRO) that oversees many brokerages. Therefore, along with other similar investment apps, Robinhood is required to deal fairly with their customers and have a fiduciary duty "under the antifraud provisions of the federal securities laws and SRO rules, including SRO rules relating to just and equitable principles of trade and high standards of commercial honor."[35]

An important aspect of a duty of fair dealing to their clients is the suitability obligation, which requires a broker-dealer to make recommendations consistent with customer interests.[36] Broker-dealers are also required under certain circumstances, such as when making a recommendation, to disclose material conflicts of interest to their customers, in some cases at the time of the transaction's completion.[37] "The federal securities laws and FINRA rules restrict broker-dealers from participating in certain transactions that may present particularly acute potential conflicts of interest."[38]

Money on Robinhood is also protected by the Securities Investor Protection Corporation (SIPC), which protects up to $250,000 for cash claims and $500,000 for securities.[39] FINRA and SEC report to SIPC concerning member broker-dealers who are in or approaching financial difficulty.[40] "If SIPC determines that the customers of a member require the protection afforded by the Act, it initiates steps to commence a customer protection proceeding."[41]

Other digital investment apps providing automated, algorithm-driven investment services with little to no human supervision, like Acorns or Betterment, are considered robo-advisors and must register with the SEC as "Registered Investment Advisors" (RIA). Most robo-advisor apps are members of FINRA as well, and depending on the services they offer, may have a separate entity as a broker-dealer to execute their users' trades.[42] Assets managed by robo-advisors are not insured by the Federal Deposit Insurance Corporation (FDIC), as they are securities held for investment purposes, not bank deposits.[43] However, assets managed by

[33] *See* Sraders, *supra* note 5.
[34] *Id.*
[35] SEC, STUDY ON INVESTMENT ADVISORS AND BROKER-DEALERS iv (2011), https://www.sec.gov/files/913studyfinal.pdf.
[36] *Id.* at 59.
[37] *See id.* at 60.
[38] *Id.* at iv.
[39] *See* Lorie Konish, *Robinhood Debate Highlights the Difference between FDIC and SIPC Protection*, CNBC (Dec. 14, 2018), https://www.cnbc.com/2018/12/14/robinhood-debate-highlights-differences-in-fdic-and-sipc-protections.html.
[40] SIPC, 2018 ANNUAL REPORT (2019), https://www.sipc.org/media/annual-reports/2018-annual-report.pdf.
[41] *Id.* at 4.
[42] *See* Betterment Res. Ctr., *supra* note 8.
[43] *See* Konish, *supra* note 39.

robo-advisor apps are typically protected by the SIPC for up to $500,000 per account against missing assets.[44]

As RIAs, these robo-advisors have a fiduciary duty to serve their app users best interests, including an obligation not to subordinate the user's interests to their own.[45] A robo-adviser "that has a material conflict of interest must either eliminate that conflict or fully disclose to its users all material facts relating to the conflict."[46] Further, the Investment Advisers Act of 1940 "prohibits an investment adviser, acting as principal for its own account, from effecting any sale or purchase of any security for the account of a client, without disclosing certain information to the client in writing before the completion of the transaction and obtaining the client's consent."[47]

The rise of digital investment and personal finance startups` could pose a set of unique challenges to financial regulation. Fintech startups present a particularly acute problem from a systemic risk perspective.[48] Their size and business models leave them more vulnerable to adverse economic shocks than large financial institutions, and those shocks are more likely to spread to other firms in the industry.[49]

## II. THE PRICE OF COMMISSION-FREE TRADING: THE "PAYMENT FOR ORDER FLOW" MODEL

### *A. The "Race to Zero:": Elimination of Online Trading Commissions*

Due to the built-in economies of scale of fintech startups and the digital technology they employ, the marginal cost of serving one more customer is generally smaller than the same marginal cost for more established competitors. Investment apps, including Robinhood and Acorns, have accumulated and drawn millions of users, mostly younger people, by marketing themselves with commission-free or low-cost investing and being mobile-friendly.[50] Conversely, since the start of 2013, the year of Robinhood's launch, traditional broker-dealers have seen a lower return for their investors, partially due to the increased competition from fintech startups with a zero-commission business model.[51] For instance, both Charles Schwab and TD Ameritrade have had returns below S&P 500 levels since 2013, averaging 11 percent per year.[52] Charles

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[44] *See id.*
[45] *See* STUDY ON INVESTMENT ADVISORS AND BROKER-DEALERS, *supra* note 35, at iii.
[46] *See id.*
[47] *Id.*
[48] William Magnuson, *Regulating Fintech*, 71 VAND. L. REV. 1167, 1171–72 (2018).
[49] *Id.* at 1172.
[50] Sraders, *supra* note 5; *see also* Dan DeFrancesco, *Investing App Acorns Nabbed $105 Million in Funding and Now Has a Higher Valuation than Robo Giant Betterment*, BUSINESS INSIDER (Jan. 28, 2019), https://www.businessinsider.com/acorns-raises-105-million-in-funding-2019-1.
[51] *See* Fitzgerald, *supra* note 10.
[52] *Id.*

Schwab returned a ,mere 7.9% between 2013 and 2019, while TD Ameritrade fared worse at just below 5% a year in the same period.[53]

Dubbed the "Robinhood effect," the intense competition from digital investment and personal finance apps have pressured major brokerages to eliminate transaction fees, with many cutting commissions altogether.[54] So how can fintech startups like Robinhood sustain this zero-commission model without incurring huge losses or going bust?

Without receiving any commission directly from its app users, Robinhood can still tap several other revenue streams available to broker-dealers: "securities lending, interest on cash held in brokerage accounts, margin lending and routing order flow to exchanges."[55] In particular, the practice of sending customer orders to high-frequency traders in exchange for cash is a controversial but legal in the brokerage industry known as "payment for order flow."[56] Robinhood credited this practice as the reason they made free trading possible: "The revenue we receive from these rebates helps us cover the costs of operating our business and allows us to offer commission-free trading."[57] In fact, the app was bringing in more than 40% of its revenue in early 2018 from selling its customers' orders to high-frequency trading firms or market makers, like Citadel Securities and Two Sigma Securities.[58]

### *B. The "Payment for Order Flow" Practice and Its Risk to Consumers*

"Payment for order flow" is the widespread practice in which over-the-counter ("OTC") market makers make cash payments to retail brokerage firms in exchange for marketable retail customer order flow.[59] These market makers are typically large financial institutions that act as wholesalers by buying and selling securities to satisfy the

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[53] *Id.*
[54] *See* Fitzgerald, *supra* note 9.
[55] *See* Darden, *supra* note 19, at 5.
[56] *See* Sraders, *supra* note 5.
[57] *A Letter from Robinhood Co-Founder & Co-CEO Vlad Tenev*, ROBINHOOD, (Oct. 12, 2018), https://blog.robinhood.com/ news/2018/10/12/a-letter-from-robinhood-co-founder-amp-co-ceo-vlad-tenev.
[58] *See* Sraders, *supra* note 5.
[59] Exchange Act Rule 10b-10 defines "payment for order flow" to include "any monetary payment, service, property, or other benefit that results in remuneration, compensation, or consideration to a broker or dealer from any broker or dealer, national securities exchange, registered securities association, or exchange member in return for the routing of customer orders by such broker or dealer to any broker or dealer, national securities exchange, registered securities association, or exchange member for execution, including but not limited to: research, clearance, custody, products or services; reciprocal agreements for the provision of order flow; adjustment of a broker or dealer's unfavorable trading errors; offers to participate as underwriter in public offerings; stock loans or shared interest accrued thereon; discounts, rebates, or any other reductions of or credits against any fee to, or expense or other financial obligation of, the broker or dealer routing a customer order that exceeds that fee, expense or financial obligation." 17 C.F.R. § 240.10(b)–10(d)(8).

market.[60] Market makers earn most of their revenues by charging a spread on the buy and sell price and transacting on both sides of the market.[61] Investors who want to buy securities get charged the asking price, which is always set marginally higher than the market price.[62] The spreads between the price investors receive and the market prices are the profits for the market makers.[63]

Market makers are particularly interested in order flow from the retail sector because retail investors are, on average, less informed than other traders about short-term price fluctuations.[64] Therefore, trading against retail investor order flow enables market makers to take advantage of information asymmetries between market participants and reliably profit from people who are not professional traders.[65] "Typically, dealers that pay to receive retail customer order flow will guarantee executions of that order flow with some amount of average price improvement over the national best bid or offer ("NBBO") and with a separate payment to retail brokers for directing customer orders to them."[66]

The SEC has stated that a broker-dealer does not necessarily violate its best-execution obligation merely because it receives payment for order flow.[67] At the same time, the SEC has stated that the existence of payment for order flow raises the potential for conflicts of interest for broker-dealers handling customer orders.[68] To date, the SEC has pursued an approach based primarily on disclosure to address concerns about the potential conflicts of interest caused by the practice of "payment for order flow."[69]

As the SEC has stressed, a broker-dealer's order-routing decisions are subject to its duty of best execution.[70] That duty requires a broker to seek to execute a customer's order at the most favorable terms reasonably available under the circumstances.[71] Broker-dealers must also conduct regular and rigorous reviews of their order-routing practices and execution quality.[72]

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[60] Barclay Palmer, *Broker vs. Market Maker: What's the Difference?*, INVESTOPEDIA (July 28, 2019), https://www.investopedia.com/ask/answers/06/brokerandmarketmaker.asp.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] *Memorandum to Equity Market Structure Advisory Committee: Certain Issues Affecting Customers in the Current Equity Market Structure*, at 6, SEC (Jan. 26, 2016), https://www.sec.gov/spotlight/equity-market-structure/issues-affecting-customers-emsac-012616.pdf [hereinafter *Memorandum*].
[65] *Id.*
[66] *Id.*
[67] *See* Payment for Order Flow, Final Rules, Securities Exchange Act Release No. 34-34902 (Oct. 27, 1994), 59 FR 55006, 55009 (Nov. 2, 1994).
[68] *Id.*
[69] *Id.*
[70] SEC, *Best Execution, Investor Information-Fast Answers*, SEC (May 9, 2011), https://www.sec.gov/fast-answers/answersbestexhtm.html.
[71] *See* Payment for Order Flow, *supra* note 67.
[72] *Id.*

There can be material economic incentives for a broker to send its marketable retail orders to market makers that pay for order flow. "These economic incentives create potential conflicts with a broker's duty of best execution and may cause observers to question the rigor with which a broker seeks to obtain the best execution for its customer orders."[73] Without payment for order flow, it is possible that market makers could have been motivated to quote more competitively, which means retail investors could have received better prices for their orders.[74] The other side of the argument claimed that the practice of payment for order flow benefit investors indirectly "by subsidizing low commission rates and other services the customers receive from their brokers."[75] Additionally, retail marketable orders routed pursuant to payment for order flow arrangements are generally executed at a faster pace and more often than not at the NBBO or better.[76]

### *C. Robinhood's Substantial Engagement in the Practice of "Payment for Order Flow"*

According to Robinhood's Fourth Quarter 2019 SEC Rule 606 Disclosure Report, no customers specifically instructed their orders routed to a particular venue for execution.[77] Conversely, that quarter, TD Ameritrade routed only 32% of its customer's orders to market makers.[78] Per Robinhood's quarterly report, users' trades were all routed to high-frequency traders like Citadel Securities (65.5%), Wolverine Securities (11.66%), and Virtu Americas (6.82%).[79] Of these market makers, Citadel was fined $22 million by the SEC for securities law violations in 2017;[80] Wolverine Securities paid a $1 million fine to the SEC for insider trading;[81] and as of December 2018, Virtu Americas settled disciplinary proceedings involving more than 50,000 instances of trading violations and was censured by FINRA for trading violations.[82]

Not only does Robinhood engage in the practice of payment for order flow, but the company appears to be selling their app users' orders for over ten times as much as other brokerages who engage in the

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[73] *See Memorandum*, *supra* note 64, at 9.
[74] *Id.* at 9–10.
[75] *Id.*
[76] *Id.*
[77] Robinhood Financial LLC, *SEC Rule 606 Report Disclosure Fourth Quarter 2019*, ROBINHOOD, https://cdn.robinhood.com/assets/robinhood/legal/RHF%20SEC%20Rule%20606%20Report%20Disclosure%20-%20Q4%202019.pdf [hereinafter *Robinhood Rule 606 Report*].
[78] TD Ameritrade, Inc., *SEC Rule 606 Report Disclosure Fourth Quarter 2019*, TD AMERITRADE, https://www.tdameritrade.com/retail-en_us/resources/pdf/AMTD2055.pdf.
[79] *See* Robinhood Rule 606 Report, *supra* note 77.
[80] *See* Kane, *supra* note 14.
[81] *Id.*
[82] Leah McGrath Goodman, *Wall Street Firm Founded by Trump's Army Secretary Nominee Violated Trading Rules for Years*, NEWSWEEK, (Jan. 15, 2017), https://www.newsweek.com/wall-street-firm-trump-army-secretary-nominee-violated-trading-rules-538630.

practice.[83] Among broker-dealers that route their order flow to market makers, the practice typically only constitutes a small percentage of their revenue.[84] But for Robinhood, selling customers' orders to high-frequency trading firms constituted more than 40% of its revenue.[85] More concerningly, unlike any other brokerages, in 2018, the app started filing Rule 606 disclosures on order flow payments for dollars traded rather than shares traded, making it impossible to compare Robinhood's payments with others.[86]

In the Third Circuit case *Newton v Merrill, Lynch, Pierce, Fenner & Smith*,[87] the court held that "[t]he duty of best execution . . . requires that a broker-dealer seek to obtain for its customer orders the most favorable terms reasonably available under the circumstances." In that case, the market maker executed their customer's orders at the NBBO price when they knew that price was inferior, and at the same time, they were trading at the more favorable price for their own accounts.[88] The court ruled that brokerages are not allowed to inflate their profit margins at the expense of their investor clients in this way.[89]

Although Robinhood itself does not seem to be engaging in the same practice as the market maker in *Newton*, the high-frequency traders they sell to are essentially using Robinhood as an intermediary without directly breaching their duty of best execution since these orders are routed to them and not directly from the app users, taking advantage of the retail investors by only offering the NBBO price instead of the best price they can obtain. Glaringly, Robinhood has a substantial conflict of interest here: the company has the duty of best execution to obtain for its users the most favorable price reasonably available. But at the same time, Robinhood is getting significant rebates from these high-frequency traders, which use their technological advantage to exploit the order flow they get indirectly from retail investors who use Robinhood. Robinhood in turn benefits from indulging in this practice, since the significant revenue it gets supports the company's commission-free business model and helps expand its client base.

In fact, Robinhood was fined $1.25 million fine by one of its regulators in December 2019, FINRA, which charged the brokerage with not following "best execution" practices from October 2016 to November 2017.[90] FINRA charged that in this timeframe, Robinhood did not reasonably consider where it could find the highest-quality trades for its

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[83] *See* Kane, *supra* note 14.
[84] *Id.*
[85] *See* Foxman, Verhage, and Woolley, *supra* note 13.
[86] *Id.*
[87] 135 F.3d 266, 270 (3d Cir. 1998).
[88] *Id.*
[89] *Id.*
[90] Dan DeFrancesco, *Robinhood Just Got Fined $1.25 Million by Its Regulator for How It Executed Trades — and It Highlights the Issues that Can Arise with Payment for Order Flow*, MARKETS INSIDER (Dec. 19, 2019), https://markets.businessinsider.com/news/stocks/robinhood-fined-by-finra-for-violating-best-execution-trading-laws-2019-12-1028776673.

users, focusing only on existing routing partners that paid Robinhood for orders instead of exploring alternatives.[91] It further commented that brokerages that engage in the practice of "payment for order flow" are obliged to either conduct an order-by-order review or implement a "regular and rigorous" review program.[92] Robinhood responded that this is no longer a problem for its current users and that the company had since implemented a better way to match traders with best-execution practices.[93]

Robinhood has also claimed in December 2019 that it is also a clearing broker and does not need to route its users' trades to market makers.[94] However, as of its latest quarterly report, Robinhood is still routing all its users' trades to high-frequency traders.[95]

## III. Branching into Commercial Banking: What Lies Ahead?

There is a growing trend of fintech startups adding banking options to their product and service offerings. In recent years, Robinhood, Coinbase, and Circle have announced their intentions to pursue national banking charters.[96] No doubt, these apps hope to build a larger user base on top of its existing millions of users by leveraging software scalability to provide more competitive returns and pricing than the traditional players in the banking sector. But so far, fintech startups have made scant progress toward winning banking charters, particularly as regulator concerns over digital financial services have grown.[97] Some members of the U.S. Federal Reserve have voiced concerns over fintech's risk management capabilities.[98] Consequently, fintech startups with ambitions of operating a full-service bank have few alternatives to pursue.

In December 2018, Robinhood unveiled its no-fee checking and savings accounts with no minimums, ATM fees, penalty charges, or foreign transaction fees.[99] Noticeably, the app was also offering a 3% interest rate, which was well above the industry average 0.08% yield on U.S. checking accounts and the 0.1% average on savings accounts.[100]

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[91] *Id.*
[92] *Id.*
[93] *Id.*
[94] *What's Clearing by Robinhood?*, ROBINHOOD, https://robinhood.com/support/articles/ 360001397126/whats-clearing-by-robinhood (last visited Apr. 5, 2020).
[95] *See* Robinhood SEC Rule 606 Report, *supra* note 77.
[96] Craig Russo, *Robinhood Looks to Offer Banking Products*, SLUDGEFEED (Jun. 21, 2018), https://sludgefeed.com/robinhood-looks-into-banking-products.
[97] Julie Verhage, *No Banking Charter? No Problem. Fintech Companies Team Up With Small-town Banks*, BLOOMBERG (Sep. 23, 2019), https://www.bloomberg.com/news/articles/2019-09-23/no-banking-charter-no-problem-fintechs-team-up-with-small-town-banks.
[98] *See id.*
[99] Josh Constine, *Robinhood Launches No-Fee Checking/Savings with Mastercard & the Most ATMs*, TECHCRUNCH (Dec. 13, 2018), https://techcrunch.com/2018/12/13/robinhood-free-checking-and-savings-accounts.
[100] Kate Rooney, *Bank Analyst Rips Robinhood's New Savings Account Plan, Says Regulators May Get Involved*, CNBC (Dec. 14, 2018),

However, the fine print on its website inconspicuously stated that the offering was not a bank account.[101] Robinhood stated in its disclosures that these "checking and savings accounts" would have been covered by the Securities Investor Protection Corporation (SIPC).[102] But these new products saw swift opposition from regulators who questioned the promised SIPC insurance, which is meant for brokerage accounts—not for savings products.[103] Only a day after its launch, Robinhood said they would re-brand and re-name these products after the "confusion."[104]

To engage in the business of banking—taking deposits and making loans—fintech startups typically require a bank charter in their name.[105] The bank charter comes with some major benefits. Under existing U.S. law, only chartered depository institutions have exclusive rights to take insured deposits from the public, which provides an extremely cheap source of funding.[106] Besides, insured depository institutions (IDIs) can also export interest rates nationwide under the Exportation Doctrine, since expanded to permit state and national banks to preempt a various states' consumer-financial-protection laws.[107]

The absence of a bank charter also means that fintech startups cannot avail itself of the preemption powers, forcing them to comply with the laws of each state in which they intend to provide their banking services.[108] Consequently, the most common business model for startups has been to enter into a partnership with a relatively small chartered bank, enabling them to operate on a much wider scale without the added burden of state-by-state compliance.[109] Robinhood, SoFi, Betterment, Wealthfront, and CreditKarma have all launched FDIC-insured, high-yield accounts this year by partnering with a bank.[110]

These high-yield cash management accounts and savings accounts have similarities. They "sweep" customers' money from a brokerage account into various FDIC-insured bank accounts.[111] Because these firms deposit the money across multiple banks, the insurance can be higher than the standard $250,000 offered per bank. In Robinhood's case, accounts are insured up to $1.25 million.[112] Robinhood said its partners include

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https://www.cnbc.com/2018/12/14/bank-analyst-rips-robinhoods-new-savings-accounts-says-regulators-may-get-involved.html.

[101] *See id.*

[102] *See* Konish, *supra* note 39.

[103] *See* Rooney, *supra* note 16.

[104] *See id.*

[105] MICHAEL S. BARR, HOWELL E. JACKSON, AND MARGARET E. TAHYAR, FINANCIAL REGULATION: LAW AND POLICY 165 (2018).

[106] *See id*. at 184.

[107] John Hannon, Note, *The True Lender Doctrine: Function over Form as a Reasonable Constraint on the Exportation of Interest Rates*, 67 DUKE L.J. 1261, 1272 (2018).

[108] *See* Barr, *supra* note 105, at 184–86.

[109] *See id.*

[110] *See* Rooney, *supra* note 16.

[111] *Id.*

[112] *Id.*

Goldman Sachs, HSBC Bank, Wells Fargo Bank, Citibank, Bank of Baroda, and U.S. Bank.[113]

There are two potential consumer protection issues for these app-based "cash management accounts" or "sweep programs." The first is broker-dealers' use of idle customer assets. The second concerns the different SIPC and FDIC protections afforded to these accounts in case of liquidation.

Regarding the first issue, SEC Rule 15c3-3(e) requires that broker-dealers place all customer cash in a separate bank account titled the "Special Reserve Bank Account for the Exclusive Benefit of Customers."[114] Broker-dealers can circumvent the requirement to place customer funds into a "Special Reserve Account for the Exclusive Benefit of Customers" by "sweeping" customer cash off their books and depositing the funds into either a bank or a money market fund.[115] This explains high interest "cash management accounts" offered by these fintech startups. Current SEC rules protect customers by ensuring that they are informed about sweep programs before their funds are swept.[116] Although FINRA has not finalized its sweep program rules, the self-regulatory organization has proposed rules which would strengthen the existing SEC customer protection requirements by requiring that customers know the most important terms of the sweep products, namely the interest rate and the sweep counterparty.[117]

Affiliate banks incentivize investment apps to encourage users to participate in so-called "cash management accounts" by offering paid fees or other benefits to sweep customer cash even if sweeping their uninvested cash is not in the best interest of the users. Depending on users' risk profile, returns may not adequately compensate them for the counterparty risk created by sweeping the cash.[118] Additionally, these investment apps could also choose banks and money market funds that pay higher fees or offer more benefits for their future development but lower returns to customers when compared to the industry.[119] Right now, per SEC and FINRA rules, the onus is on users' and not the app to understand the risks associated with sweep programs.[120]

The second issue concerns the difference between SIPC and FDIC protections. In December 2018, when Robinhood rolled out its no-fee checking and savings accounts with 3% interest rate, it disclosed that the

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[113] *Id.*
[114] 17 C.F.R. § 240.15c3-3(e) (2015).
[115] *See id.*
[116] George Tepe, Note, *Broker-Dealer Use of Idle Customer Assets: Customer Protection with Sweep Programs and Securities Lending*, 2016 COLUM. BUS. L. REV. 823, 833–34 (2016).
[117] *See Regulatory Notice 15-22, Discretionary Accounts and Transactions*, FINRA (2015), http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory_Notice_15-22.pdf.
[118] *See* Tepe, *supra* note 116, at 851.
[119] *See id.*
[120] *See id.*

accounts would be covered by the SIPC.[121] However, SIPC's CEO swiftly responded that it would not insure checking and savings accounts the way Robinhood had claimed.[122] Consequently, Robinhood retracted that controversial launch, and returned in October 2019 to offer cash management accounts, which are similar to savings accounts.[123] This time around, the product is covered by the FDIC rather than the SIPC through Robinhood's partnership with various chartered banks.[124]

This debacle highlighted the crucial difference between the protections offered by the FDIC and SIPC. The FDIC, which began operations in 1933, administers deposit insurance and the fund reserved to protect deposits and resolve failed banks, known as the Deposit Insurance Fund.[125] After the Dodd-Frank Act was enacted, the standard maximum deposit insurance amount is $250,000 per ownership account category, per depositor, per institution.[126] Therefore, the FDIC insures individual deposits in one insured bank separately from individual deposits in another separately chartered insured bank.[127] For example, if a person has a certificate of deposit at Bank A and has a certificate of deposit at Bank B, the amounts would each be insured separately up to $250,000.[128] However, funds deposited in separate branches of the same insured bank are not separately insured.[129]

Conversely, SIPC, on the other hand, was created by the Securities Investor Protection Act in 1970 to protect a broker-dealer's customer from the loss of cash and securities if the broker-dealer has to be liquidated.[130] SIPC's guarantees apply only to the broker-dealer's custody function, which means SIPC only would cover customers' cash and securities in their brokerage accounts when the firm enters liquidation.[131] SIPC's CEO, therefore, determined that its insurance would not apply to "checking and savings accounts" of Robinhood because the insurance saw the money put into these accounts as loans by customers to the investment app, and not cash or securities that are in their brokerage accounts.[132] Additionally, SIPC does not insure individuals in the event their securities' value declines.[133] It also does not cover consumers who were sold worthless

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[121] Josh Constine, *Robinhood Lacked Proper Insurance So Will Change Checking & Savings Feature*, TECHCRUNCH (Dec. 14, 2018), https://techcrunch.com/2018/12/14/robinhood-insurance-sipc.
[122] *See id.*
[123] *See* Rooney, *supra* note 16.
[124] *See id.*
[125] *See* Barr, *supra* note 105.
[126] *Your Insured Deposits*, FEDERAL DEPOSIT INS. CORP., https://www.fdic.gov/deposit/deposits/brochures/your-insured-deposits-english.html (last updated Nov. 12, 2019).
[127] *Id.*
[128] *Id.*
[129] *Id.*
[130] *See* Barr, *supra* note 105.
[131] *What SIPC Protects*, SEC. INV'R PROT. CORP., https://www.sipc.org/for-investors/what-sipc-protects (last visited Dec. 21, 2019).
[132] *See* Constine, *supra* note 121.
[133] *See What SIPC Protects*, *supra* note 131.

investments, received bad advice, or steered toward inappropriate investments .[134] These carve-outs and caveats further highlight SIPC's diminished consumer protections compared to the FDIC. So, before signing up for a new "cash management account," users should read the fine print and carefully choose their insurance coverage in the event their chosen finance app's company goes into liquidation.

Another area to keep an eye on for the future regulatory landscape is the proposed special charter for non-bank fintech companies (the "fintech charter") by the Office of the Comptroller of the Currency (OCC) as a possible avenue for fintech firms to access the nationwide financial system without having be licensed in all 50 states.[135] The so called "fintech charter" was recently struck down by a judge of the United States District Court for the Southern District of New York, holding that the fintech charter is beyond the OCC's authority.[136] The fate of the charter however, is still pending from an appeal by the OCC.[137]

## CONCLUSION

Low-cost or free investment apps are here to stay. Despite increased scrutiny of risk management and consumer protections practices, dubious behaviors and shady revenue streams remain the lifeblood of fintech startups. As they continue to generate higher investment returns and supplant established industry players, confrontations with regulators like FINRA will become increasingly common. Robinhood was FINRA's first causality for failing to follow its fiduciary duties, but it will surely not be the last.[138] The rise of "cash management accounts" and associated "sweep programs" promise to be new hotbeds for trouble in the consumer protection space.

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[134] *Id.*

[135] Sarah Grotta, *Is This the End for the OCC Fintech Charter?*, PAYMENTS JOURNAL (Oct. 23, 2019), https://www.paymentsjournal.com/is-this-the-end-for-the-occ-fintech-charter/.

[136] Daniel S. Cohen, *Federal Court Strikes Down Fintech Charter, Calling Other Nondepository Charters Into Question*, NAT'L LAW REVIEW (Oct. 28, 2019), https://www.natlawreview.com/article/federal-court-strikes-down-fintech-charter-calling-other-nondepository-charters.

[137] *Id.*

[138] *See* DeFrancesco, *supra* note 90.