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FINANCIAL REGULATION

Robinhood in Talks to Settle Finra Probes Into Options-Trading Practices, Outages

Stock-trading app says in filing it is also being examined by SEC and states

Robinhood CEO Vlad Tenev

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Robinhood Markets Inc. is in talks to pay a fine to settle investigations into its options-trading practices and outages the stock-trading app suffered in March 2020, according to a securities filing.

The Securities and Exchange Commission, state regulatory authorities and the Financial Industry Regulatory Authority, Wall Street's self-regulatory arm, are examining Robinhood's conduct in those matters, including how Robinhood "displays cash and buying power to customers and its options trading approval processes," the company said in the filing.

Two subsidiaries—Robinhood Financial and Robinhood Securities—are currently negotiating a settlement with Finra over the outages and the options-trading practices, which could include charges of violations of Finra rules, a fine, restitution to customers and the hiring of a compliance consultant. The probes could cost the company at least $26.6 million, according to the filing.

Robinhood also drew the interest of prosecutors and regulators, and the ire of many customers, for its decision last month to restrict purchases of GameStop Corp. and other highflying stocks. The U.S. attorney for the northern district of California, the SEC, Finra and the attorneys general for New York and other states have sent Robinhood inquiries about the trading restrictions, according to the filing. Robinhood also faces dozens of lawsuits from users over the trading restrictions.

Perhaps no company has benefited more from the retail stock-trading boom of the past year than Robinhood. Its ease of use and zero-commission model brought millions of new users to its app in 2020. But a surge in trading activity during the market swoons of last March strained Robinhood's infrastructure, causing its trading platform to go off-line for all or part of three days that month and prompting user outrage.

As more inexperienced traders came to Robinhood, and the markets, the company came under fire for how easy it made it to trade risky options. In December, the Massachusetts securities regulator filed a complaint against Robinhood, accusing the company of approving customers to engage in options trading without having the necessary qualifications. In its response, Robinhood said it was legal to allow customers to trade options and for Robinhood "to approve customers for options trading based on prior options experience."

The Massachusetts complaint came several months after Alex Kearns, a 20-year-old student, died by suicide after thinking he had racked up big options-trading losses on Robinhood because of an incomplete display of his positions in his Robinhood app.

His family recently filed a wrongful-death lawsuit against Robinhood, accusing the company of contributing to Mr. Kearns's death through "misleading communications" about his investments and "virtually non-existent" customer service. They are seeking unspecified damages.

About 13% of Robinhood users traded options through the app, Robinhood Chief Executive Vlad Tenev said in written testimony ahead of a congressional hearing last week. Robinhood assesses customers' investment experience and knowledge when deciding whether to approve their requests to buy and sell those contracts. Last year, after Mr. Kearns's death, Robinhood redesigned its options-trading interface to add more investor protections and made it harder for new customers to qualify to trade certain kinds of options strategies.

Yet Mr. Tenev also disclosed in his testimony that Robinhood recently discovered that some customers who traded call options were behaving in a financially irrational manner.

Call options give investors a right, but not an obligation, to buy a specific amount of stock at a specific price, known as the strike price, during a specific window of time before they expire. If a call option is "out of the money," meaning the price of the underlying stock is below the strike price, a customer is better off letting the option expire.

In January, Robinhood noticed some users "were occasionally exercising OTM options, causing them to suffer losses immediately upon exercise," Mr. Tenev said. Robinhood put a warning system in place and required customers looking to exercise out-of-the-money options to speak with a company representative first. On Jan. 29, it stopped allowing customers to exercise out-of-the-money options.

Options trading is especially lucrative for Robinhood. Most of the company's revenue comes from payments it receives when it routes customers' orders to high-speed traders. That business, known as "payment for order flow," earned Robinhood about $440 million for options trades in 2020, compared with about $247 million for stock trades, according to securities filings.

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