October 1, 2021

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Request for Information and Comments on Broker-Dealer and Investment Adviser Digital Engagement Practices, Related Tools and Methods, and Regulatory Considerations and Potential Approaches; Information and Comments on Investment Adviser Use of Technology To Develop and Provide Investment Advice (Release Nos. 34–92766; IA–5833; File No. S7–10–21)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned request for information ("RFI" or "Release") issued for public comment by the Securities and Exchange Commission ("SEC" or "Commission").[2] The Commission is gathering information about the increased use of "digital engagement practices" ("DEPs"). Those practices include the creation of online trading platforms and mobile apps that appeal to an increasing number of retail investors, especially young investors. While these platforms and apps may make trading easier and more accessible, they often include features intentionally designed to lure investors, manipulate their behavior, and maximize their trading activity to generate huge revenues and profits for brokers, often at the expense of those investors.

We therefore applaud the Commission for undertaking a close examination of DEPs and gathering information from all stakeholders, with an eye toward possible reforms that may be necessary to protect investors from the harmful effects of DEPs. New technologies can often confer significant benefits on investors and markets, but they can also pose significant risks and

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 86 Fed. Reg. 18,378 (Apr. 8, 2021).

inflict substantial harm. To realize the benefits while minimizing the risks, technology must, as Chairman Gensler recently explained, be brought within a strong regulatory framework.[3]

We also applaud the Commission's decision to include in the Release a survey that seeks information from individual investors so that the agency can understand their experiences with DEPs. Typically, the SEC is bombarded with comment letters from the financial services industry that far outnumber the submissions from retail investors or public interest advocates. Indeed, the SEC hears constantly from the big Wall Street financial firms like Goldman Sachs, the hedge funds like Melvin Capital, and the HFT firms like Citadel who use armies of lobbyist, lawyers, and political allies to derail, weaken, or rig the rules in their favor and maximize their profits—profits that come largely from the pockets of countless individual retail investors. The survey in the Release is an opportunity for those investors with a real stake in the use of DEPs to have their voices heard and help balance the advocacy submitted to the SEC.

INTRODUCTION AND OVERVIEW

DEPs have the potential to benefit investors, as they may help promote investor education, facilitate efficient access to the markets, and help more Americans—including young and minority investors—build wealth and achieve their long-term financial goals. However, as emphasized in the Release, these technologies can, and in some cases clearly do, pose serious risks to investors. Some of the most prominent platforms are motivated by a powerful conflict of interest, as they are designed not to serve the interests of investors but to generate huge trading volume that in turn, through payment for order flow ("PFOF"), creates huge revenues and profits for the brokers offering them. They often bombard investors with manipulative signals that entice or even pressure them into trading as much as possible regardless of how it might affect their financial health. As a result, investors may trade with excessive frequency and in excessively risky products, including options and securities on margin, all without clear and timely disclosure of the risks and costs involved.

A distinctive feature of these platforms, and one that can be especially harmful to investors, is the "gamification" of securities trading. This strategy entails the design and deployment of addictive, endorphin-engendering game-like features for the purpose of triggering more trading, more often, and more thoughtlessly.[4] Too often these features take an activity—investing and risking money—that requires thought, diligence, analysis, and financial wherewithal and imbue it with rapid, seemingly low-consequence, and fundamentally recreational gameplaying attributes.

---

3 The Path Forward: Cryptocurrency with Gary Gensler, Wash. Post Live Transcript (Sept. 21, 2021), https://www.washingtonpost.com/washington-post-live/2021/09/21/transcript-path-forward-cryptocurrency-with-gary-gensler/.

4 *See* Letter from R. Cook, FINRA, to Senator E. Warren ("FINRA Letter"), at 4-6 (Feb. 23, 2021), https://www.warren.senate.gov/imo/media/doc/FINRA%20Response.pdf (emphasizing that "[w]hile some of these [gamelike] offerings may be designed to better enable the delivery of information to investors or to improve investor access to firm systems and investment products and services, they may also result in increased risks to customers if not designed with appropriate compliance considerations in mind"), https://www.marketwatch.com/story/heres-another-explanation-for-thesurge-in-speculative-activity-smartphones-11611579511.

Alone and in combination, the many features of DEPs can and sometimes clearly do represent recommendations to trade but without compliance with regulatory protections such as Regulation "Best Interest" and other rules. Those rules are intended to ensure that brokers take into the account an investor's specific financial circumstances; disclose the risks and costs associated with trading; and disclose and at least mitigate any conflicts of interest incentivizing the broker.

In fact, concerns about the harm that DEPs, and gamification in particular, can and do inflict on investors are what drove the Commonwealth of Massachusetts to file an enforcement action against Robinhood last December. The company's gamification tactics were deemed so toxic that the Securities Division of Massachusetts sought not only to impose penalties against Robinhood but also to ban it entirely from the state.[5]

In short, Better Markets supports the "democratization" of finance, the ability of everyday, hardworking Americans to utilize the financial system to build wealth for important life goals. That is why, for example, Better Markets celebrated the life of John Bogle, a pioneer in creating low-cost, low fee mutual funds tied to market indices that freed Americans from broker sales pressures, and better equipped them to build wealth, buy a home, send a child to college, and enjoy a safe and secure retirement by taking advantage of compound returns without the tyranny of excessive fees.[6] It is certainly possible for DEPs to contribute to the financial well-being of Americans. However, Better Markets does not support the purported "democratization" of finance that involves the use of DEPs to manipulate and exploit retail investors, in effect inducing users to churn their own accounts so that brokers can reap the rewards from inherently conflict-ridden arrangements like payment for order flow.

OVERVIEW OF RELEASE

The Release explains that the Commission is issuing the RFI for three reasons:

1. to assist the Commission and its staff in better understanding and assessing market practices associated with the use of DEPs by firms;

2. to provide a forum for market participants (including investors) and other interested parties to share their perspectives on the use of DEPs, including the potential benefits they offer as well as the investor protection concerns they raise; and

3. to facilitate an assessment by the Commission of existing regulations and whether further regulatory action may be necessary to protect investors and maintain fair, orderly, and efficient markets.

---

5 Amended Administrative Complaint, *In re Robinhood*, Docket No. E-2020-0047 (Mass. Sec'y State, Sec. Div. 2021).

6 *See* Better Markets, John Bogle: A Tireless Advocate for the Small Investor and the Conscience of the Financial Industry (Jan. 16, 2019), https://bettermarkets.com/newsroom/john-bogle-tireless-advocate-small-investor-and-conscience-financial-industry.

As background, the Release describes a wide variety of DEPs that firms are using. They include social networking tools; games, streaks, and other contests with prizes; points, badges, and leaderboards; notifications; celebrations for trading; visual cues; ideas presented at order placement; and other curated lists or features; subscriptions and membership tiers; and chatbots.[7]

The Release also briefly highlights some of the risks and benefits associated with DEPs. For example, it notes that some DEP features have made investment platforms more accessible to retail investors (in particular younger investors) and also have led to the development of investor education tools. It further notes that DEPs can encourage retail investors to increase their contributions to retirement accounts and to engage in "other activities that are traditionally viewed as wealth-building exercises."[8]

On the other hand, the Release notes, DEPs can potentially harm retail investors to the extent they prompt them to engage in trading activities that may not be consistent with their investment goals or risk tolerance. It lists a number of specific concerns that DEPs encourage (1) frequent trading; (2) trading strategies that carry additional risk (such as options trading and trading on margin); and (3) trading in complex securities products. The Release also highlights the disturbing fact that some DEPs may employ what are known as "dark patterns," described as user interface design choices that are intentionally designed "to confuse users, make it difficult for users to express their actual preferences, or manipulate users into taking certain actions."[9]

Finally, the Release explores, and poses a number of questions about, a series of topics, including industry practices in the use of DEPs; the retail investor experience with DEPs; the benefits and risks of DEPs; the use of technology by investment advisers in providing investment advice; and relevant aspects of the current regulatory framework that may apply to brokers and advisers in the context of online platforms, apps, and other technologies. The Release closes with an appendix that includes a survey directed at retail investors, with eleven questions, entitled "Tell Us About Your Experiences With Online Trading Platforms and Investment Platforms."

SUMMARY OF COMMENTS

DEPs, as designed and deployed by a number of major brokers, pose a substantial risk of harm to retail investors, and they call for precisely the type of regulatory scrutiny that the Commission has undertaken in the Release. As it goes through this process and considers further regulatory measures that may be appropriate and necessary to protect investors, we urge the Commission to weigh these considerations:

I. The design and deployment of DEPs is driven by powerful conflicts of interest.

II. There is already ample evidence showing that DEPs can and do harm investors and potentially the markets as well.

---

7 Release at 49068.
8 Release at 49069.
9 Release at 49070.

A. DEPs can induce trading behavior that is financially counterproductive both in the short term and over time.

B. DEPS can also undermine the stability and integrity of our capital markets.

III. Many of the claimed benefits associated with DEPs are misleading or exaggerated.

A. Platforms and apps need not have gamification features to facilitate access to the financial markets.

B. Providing information can be a manipulative form of DEP.

C. The fun or pleasurable aspects of online trading can represent manipulative elements that pose risks to investors, not necessarily benefits that justify their use.

IV. The SEC has tools available to it to address issues raised by DEPs.

A. Some DEPs, alone or in combination, constitute "recommendations" that trigger the application of Regulation "Best Interest."

B. The SEC can and should ban or strengthen the regulation of Payment for Order Flow.

I. <u>THE DESIGN AND DEPLOYMENT OF DEPS IS DRIVEN BY POWERFUL CONFLICTS OF INTEREST.</u>

Some of today's dominant online trading platforms involve a profound conflict of interest between what's best for the trading platform and what's best for investors. The governing principle behind some of these platforms appears to be this simple rule: indiscriminately induce more trading, of any and all types, among as many investors as possible, to maximize trading volume and profits. In short, maximize trading to maximize revenue, regardless of the damage done to investors. They pose significant risks to their clients, some of whom are manipulated into investing—often in complex and risky investments—without understanding all of the attendant risks and costs. In reality, these platforms are not fundamentally about "democratizing finance," as the President of Robinhood likes to say; they are about maximizing profit. Brokers like Robinhood are not altruistically seeking to "democratize" trading any more than payday lenders are trying to "democratize" borrowing.

To be sure, these platforms may make stock trading easier and more accessible to a broad range of investors, including young people and minorities. But whether that's a good thing depends on how this increase in investor participation is actually accomplished and at what cost to investors. The problem is that the dominant platforms today include a host of features that go far beyond simply facilitating trading or educating investors with convenient and easy to use applications. They actually are loaded with features that have nothing to do with making stock trading more accessible to those who haven't traditionally participated in the stock market. These features are designed, alone and in combination, to swamp investors with manipulative prompts that induce them to trade as much as possible, regardless of the financial consequences.

In the case of Robinhood, that trading volume is sold to market markers in exchange for huge payments known as payment for order flow or PFOF. In fact, Robinhood reportedly makes over 80% of its revenue from PFOF. In 2020, that amounted to almost $700 million dollars. The sad fact is that PFOF inflicts yet more harm on investors, since it incentivizes brokers like Robinhood to route their clients' orders not to venues that offer the best execution prices but instead to market-makers that pay them the most for the trading volume.[10]

Other conflicts of interest may also be in play to the extent that trading platforms steer clients explicitly or subliminally to products or services that are more lucrative for the broker, such as proprietary products, those that involve third party payments, and margin services. In addition, a conflict may arise to the extent the broker is stoking retail trading volume for the purpose of generating data that it can monetize.

The problem with all of this is that the business model and the conflicts of interest that come with it pose serious risks for investors. As explained below, they induce trading activity that in many cases is not thoughtful or well-informed about the downside risks of investing, and it can lead to financial losses that are painful and in some cases ruinous. In short, investing and trading to achieve important financial goals is not fundamentally a game. And if or when the stock market experiences a significant downturn, the risk of loss associated with this approach may well become an especially harsh reality for many of these platform users.

II. THERE IS ALREADY AMPLE EVIDENCE SHOWING THAT DEPS CAN AND DO HARM INVESTORS AND POTENTIALLY THE MARKETS AS WELL.

A. DEPs can induce trading behavior that is financially counterproductive both in the short term and over time.

Despite the relative novelty of apps that make significant use of gamification and other DEP features, there is already evidence that these apps can cause investor harm, evidence that extends beyond the media reports of investors who have suffered losses or the lawsuits that have been filed against the likes of Robinhood.

For example, two scholars, drawing from a variety of literature on "1) findings from finance and economics literature on healthy investment practices, 2) the dual process theory from behavioral sciences, and 3) design metaphors used in interfaces with uncertain rewards" developed

---

10 Better Markets Fact Sheet, Payment For Order Flow: How Wall Street Costs Main Street Investors Billions of Dollars through Kickbacks and Preferential Routing of Customer Orders (Feb. 16, 2021), https://bettermarkets.com/sites/default/files/documents/Better_Markets_Payment_for_Order_Flow_Long_02-21-2021.pdf; SEC, *In Re Robinhood Financial*, File No. 3-20171 (Order Instituting Administrative and Cease and Desist Proceedings) (Dec. 17, 2020), https://www.sec.gov/litigation/admin/2020/33-10906.pdf.

"a set of design guidelines for encouraging healthy investing behaviors."[11] These guidelines include, among other things, encouraging diversification, encouraging deliberative trading, discouraging active trading, and discouraging overreaction to market news.[12] The authors then compared the guidelines to the actual functionality of trading apps, and found "that, unfortunately, popular trading apps generally do not follow design patterns that encourage healthier trading behaviors,"[13] with Robinhood in particular falling short.[14] This puts the lie to the notion that these apps are "empowering" investors or that they encourage "financial responsibility," as Robinhood's CEO claimed in testimony before Congress.[15] In fact, the design of apps like Robinhood has little to do with encouraging investors to engage in financially responsible and healthy investment behavior.

Instead, the DEPs in apps like Robinhood are designed "to encourage people to engage in trading since Robinhood is paid more if its customers trade more" through their payment-for-order-flow arrangements with internalizers."[16] And it has been known for decades that frequent trading is harmful to investors.[17] Indeed, a recent study has confirmed that Robinhood users disproportionately engage in suboptimal trading strategies and, accordingly, suffer disproportionate losses.[18] Moreover, the losses suffered by users of trading apps are not just monetary. In one widely publicized tragedy, a Robinhood user, a college student and inexperienced investor who was trading in risky options, died by suicide after logging into his account and seeing what he thought was a negative balance of over $700,000.[19] Ultimately, there is ample evidence regarding the potential harm stemming from trading apps that aggressively use gamification and other DEPs to induce frequent trading and other risky behaviors, and that evidence justifies the SEC's regulating those features more aggressively to protect investors.

---

11 Sayan Chaudhry & Chinmay Kulkarni, *Design Patterns of Investing Apps and Their Effects on Investing Behaviors*, Proceedings of the 2021 ACM Designing Interactive Systems Conference 777 (2021), https://dl.acm.org/doi/pdf/10.1145/3461778.3462008.

12 *Id.* at 784.

13 *Id.* at 777.

14 *Id.* at 784.

15 *Game Stopped Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the House Financial Services Committee* (2021) ("My parents, both of whom worked at the World Bank, instilled in me at an early age the values of financial responsibility and opportunity for all. And those values lie at the heart of Robinhood today. We fundamentally believe that participation in the U.S. capital markets is empowering"), *https://context-cdn.washingtonpost.com/notes/prod/default/documents/68530c1f-5838-4653-9147-5a342335ea6e/note/a18d56f0-fd03-4dd9-b66b-988ebe166e9f.#page=1*.

16 Melanie Cherdack, *Trading in the Time of Covid: A Robinhood Bromance*, 28 PIABA B.J. 159, 162 (2021).

17 Bob Pisani, *Attention Robinhood Power Users: Most Day Traders Lose Money*, CNBC (Nov. 20, 2020), https://www.cnbc.com/2020/11/20/attention-robinhood-power-users-most-day-traders-lose-money.html.

18 Brad M. Barber, et al., *Attention-Induced Trading Returns: Evidence from Robinhood Users* (Oct. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3715077.

19 Nathaniel Popper, *Robinhood Has Lured Young Traders, Sometimes With Devastating Results*, N.Y. TIMES (Jul. 8, 2020), https://www.nytimes.com/2020/07/08/technology/robinhood-risky-trading.html.

B. DEPS can also undermine the stability and integrity of our capital markets.

The increasing use of DEPs threatens harm not only to investors but also the integrity and even stability of the capital markets as a whole. The GameStop saga that unfolded early this year illustrated the fragility of America's securities markets and how new technology can contribute to that fragility. For example, the ease of trading through Robinhood's platforms prompted an avalanche of orders in GameStop after Reddit users and others on social media stoked an uprising against the institutional shorts that were driving the price of GameStop into a downward spiral. That sheer volume overloaded Robinhood's capacity to maintain sufficient margin with its clearinghouse, which in turn forced the platform to essentially halt trading just as the market was extremely volatile. Countless Robinhood app users were hurt in the process, prompting dozens of individual and class action lawsuits. And over Robinhood's history, its platform has proven to be especially fragile, often going dark and freezing investors out of the market.

In addition, there is little doubt that the DEP features of apps like Robinhood, including its "Top Movers" list, causes herding,[20] which can lead to market volatility, bubbles, and other negative consequences for the markets. Indeed, there is evidence that Robinhood's apps contribute to market volatility.[21] And heavy reliance on new technology always brings with it the increased risk of breakdowns if not meltdowns in trading systems, which can spark contagion.[22] These dangers will only increase as apps like Robinhood that use DEPs continue to grow and proliferate without adequate safeguards. This makes it even more urgent that the SEC act to appropriately regulate these technologies.

III. MANY OF THE CLAIMED BENEFITS ASSOCIATED WITH DEPS ARE MISLEADING OR EXAGGERATED.

Some industry advocates contend that their interests truly are aligned with their investor clients and that their platforms and apps offer huge benefits. The truth is that technologies available today, including online trading platforms and mobile apps, have the potential to help a larger, younger, and more diverse population of investors participate in the stock market in ways that can enhance their long-term financial health. Those technologies can make trading easier, educate investors, and lower costs. But many of today's DEPs are not designed and deployed to advance these goals; instead, as explained above, they are intended to induce hyperactive and often risky trading that in general degrades financial health. As it explores the use of DEPs in today's markets, the Commission must properly distinguish the claimed benefits of DEPs from their harmful effects.

---

20 Brad M. Barber, et al., *Attention-Induced Trading Returns: Evidence from Robinhood Users* (Oct. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3715077.

21 Cooper Jones, *Retail Trading and Stock Volatility: The Case of Robinhood* (2021), https://digitalcommons.usu.edu/cgi/viewcontent.cgi?article=2565&context=gradreports.

22 Reg. ATS, 17 C.F.R. §§ 242.300-304.

A. Platforms and apps need not have gamification features to facilitate access to the financial markets.

The Commission must not conflate gamification features and other DEPs that are designed to induce users to engage in certain behaviors (such as more frequent trading) with those features that simply enable access to the financial markets. Some platforms and apps can offer a number of benefits by creating easily navigable interfaces; offering clear and helpful information; and making it simple and easy to deposit money and effect trades. But there is a profound distinction between making these advantages ***available*** to investors and incorporating additional design features that ***manipulate*** investors and induce them to use these features constantly, trade excessively, and undertake poorly understood risks. If the most powerfully alluring gamification features were restricted or eliminated, there is no reason why this would necessarily limit access to markets or deprive investors of the convenient functionalities that technology can offer. To the extent that trading apps can really "democratize" finance, stronger rules regarding the use of DEPs need not interfere with that investor benefit.

B. Providing information can be a manipulative form of DEP.

The use of trading apps and platforms to impart information to investors raises special concerns. In his testimony before Congress, the Robinhood CEO sought to draw a sharp distinction between certain "gamification" features, all of which he claimed Robinhood either does not utilize or utilizes only sparingly, on the one hand, and "stock price movements, upcoming earnings calls, and breaking news [that] are for informational purposes only" on the other hand.[23] This is misleading, at best, because DEPs that provide information are often not "for informational purposes only." Robinhood is not a news app or an educational app. It is not sending users information so that users can stay informed and engage in enlightened debate. It is a trading app, and the purpose of the information it provides, and the manner in which it provides it, is plainly intended to prompt people to engage with the app, i.e. to trade.[24] And, indeed, while much popular attention has focused on features like confetti that celebrate trades (a feature Robinhood has since abandoned in the face of scrutiny), commenters have also noted that the way trading apps present market and other information may itself be a problematic gamification feature.[25]

The two academic papers discussed above shed light on this issue. In the study exploring the design features of apps that would encourage healthy investing, one of the guidelines the

---

23 *Game Stopped Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the House Financial Services Committee* (2021) (testimony of Vladimir Tenev), https://context-cdn.washingtonpost.com/notes/prod/default/documents/68530c1f-5838-4653-9147-5a342335ea6e/note/a18d56f0-fd03-4dd9-b66b-988ebe166e9f.#page=1.

24 Similarly, when Facebook sends you a notification that it is your friend John Doe's birthday, it is not doing that so that you can make sure your records on John Doe are accurate and up-to-date. It is sending you that information so that you will engage with John Doe, through Facebook, by wishing him a happy birthday.

25 *See, e.g.*, Melanie Cherdack, *Trading in the Time of Covid: A Robinhood Bromance,* 28 PIABA B.J. 159, 161–62 (2021) ("When a Robinhood investor opens the app, they are welcomed with a burst of candy colored and eye-catching offerings: showers of confetti to celebrate transactions, ***the hot pink price of bitcoin and a list of popular stocks to trade.***") (emphasis added)

authors developed is "Discourage overreaction to market news" by helping "investors interpret market news in a manner consistent with market fundamentals instead of acting on hype and behavioral factors."[26] Robinhood, according to the authors, fell short because it "Prominently features market news[,] [s]ends push notifications close to earning events[, and h]ighlights securities whose prices moved the most."[27] Similarly, in the study demonstrating that Robinhood users suffer disproportionate losses because they disproportionately engage in a suboptimal trading strategy, the trading strategy at issue is "attention-induced trading," i.e. buying and selling stocks of companies that are receiving a disproportionate amount of attention. A significant reason Robinhood users disproportionately engage in attention-induced trading is because the Robinhood app blares information to users about market news and "Top Movers" (i.e. stocks whose value has changed the most from the prior day's close), among other things. In other words, Robinhood does not simply provide information for "informational purposes only," it provides information for the same purpose, and with the same effect, as other DEPs—to induce its users to trade more.

C. <u>The fun or pleasurable aspects of online trading can represent manipulative elements that pose risks to ivnestors, not necessarily benefits that justify their use.</u>

Some tout as a benefit the ability of DEPs to enhance the investing experience by making it fun or otherwise pleasurable. But this too is misleading and indeed dangerous from an investor protection standpoint, as rewarding stock trading in this way—the classic gamification strategy—can induce precisely the type of thoughtless or even reckless trading that can prove so financially harmful. Consider a food analogy: Whether a food "tastes good" has little to do with the separate question of whether it is actually healthful or "good for you," and in the context of investor protection, it is the latter question that matters most.

It is clear that many of today's DEPs have been designed to be enjoyable to investors, for the purpose of increasing engagement. Robinhood CEO Vladimir Tenev reflected this strategy in his Congressional testimony discussing gamification. He argued that his app is built to "include features that, based on our outreach and research, customers feel familiar with and expect to see in a mobile product" and that it "provides the intuitive experience customers want."[28] This may be a credit to the marketing, research, and design teams at Robinhood if they have indeed designed apps with features that users enjoy. But this perspective obscures the more important question, which is not whether the apps are fun or enjoyable to use, but whether they induce trading activities that inflict harmful financial consequences on investors.

---

26 Sayan Chaudhry & Chinmay Kulkarni, *Design Patterns of Investing Apps and Their Effects on Investing Behaviors*, Proceedings of the 2021 ACM Designing Interactive Systems Conference 784 (2021), https://dl.acm.org/doi/pdf/10.1145/3461778.3462008.

27 Sayan Chaudhry & Chinmay Kulkarni, *Design Patterns of Investing Apps and Their Effects on Investing Behaviors*, Proceedings of the 2021 ACM Designing Interactive Systems Conference 784 (2021), https://dl.acm.org/doi/pdf/10.1145/3461778.3462008.

28 *Game Stopped Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide: Hearing Before the House Financial Services Committee* (2021) (testimony of Vladimir Tenev), https://context-cdn.washingtonpost.com/notes/prod/default/documents/68530c1f-5838-4653-9147-5a342335ea6e/note/a18d56f0-fd03-4dd9-b66b-988ebe166e9f.#page=1.

IV. THE SEC HAS TOOLS AVAILABLE TO IT TO ADDRESS ISSUES RAISED BY DEPs.

A. Some DEPs, alone or in combination, constitute "recommendations" that trigger the application of Regulation "Best Interest."

The SEC's Regulation Best Interest ("Reg. BI") was a disappointment in many respects for investors and investor advocates. Nevertheless, at the very least it provides a potential tool the SEC can use to address concerns raised by DEP features, including the obligation it imposes on broker-dealers to act in clients' best interest when making "recommendations. Reg. BI applies whenever a broker makes "a recommendation of any securities transaction or investment strategy involving securities (including account recommendations) to a retail customer."[29] Thus, the literal wording of Reg BI extends beyond just recommending specific stocks. And it is reasonable to conclude that some of the DEPs in use today, alone or in combination, constitute "recommendations" within the meaning of the rule, as they directly or indirectly steer investors into intensive trading in securities (often specific securities), trading in groups of securities, and trading through the use of various types of accounts.

The guidance in the adopting release[30] ("Reg. BI Release") supports a broad reading of the "recommendation" test. First, the Reg. BI Release explains that the rule will turn on the facts and circumstance of the particular situation, so it is intended to be flexibly applied.[31] Second, the Reg. BI Release offers as a guideline whether the communication could reasonably be viewed as a call to action or reasonably would influence an investor to trade a particular security or group of securities.[32] Many of the DEPs used by trading platforms are nothing if not a call to action to trade. Moreover, this language from Reg. BI brings to mind DEPs that flag groups of securities for their users, such as the most popular stocks or the largest movers.

Third, the Reg. BI Release expressly states that Reg BI "should apply broadly to recommendations of securities transactions and investment strategies involving securities."[33] And it drives home the point by explaining that recommendations about types of accounts, such as day trading, margin, or option accounts, are covered by the rule regardless of whether or not they involve specific securities transactions.[34] This RFI also correctly suggests that recommendations are often associated with DEPs: It suggests that brokers, when determining if they are making a recommendation, should evaluate to what extent DEPs are affecting the behavior of a statistically significant number of retail investors.[35] That's clearly the case with many of the DEPs deployed on the major online trading platforms, which can fairly be presumed to be intended to affect user behavior.

---

29 17 CFR § 240.15l-1(a)(1).
30 Regulation Best Interest, 84 Fed. Reg. 33,318 (Jul. 12, 2019).
31 Reg. BI Release at 33,335.
32 Reg. BI Release at 33,335.
33 Reg. BI Release at 33,339.
34 Reg. BI Release at 33,339.
35 RFI at 49,078.

Finally, this analysis is supported by one of the bedrock principles of securities regulation articulated by the Supreme Court decades ago: What counts in determining whether the law applies are not the labels and formalities accompanying an investment offering, but the economic realities underlying the product or behavior at issue.[36]

To appreciate these arguments, it's important to appreciate the extraordinary nature and number of the design features found on modern trading apps that induce and reward trading. Consider some specific features. They include:

- Celebrations for trading, including confetti or applause;
- Games and contests with leaderboards and prizes, ranging from free stock to cash and free subscriptions;
- Embedded social networking tools, including the ability to mimic the trading of others;
- Notifications and nudges via email or text, showing which stocks are up or down; lists of the most popular or top moving stocks; and the number of days since the user's most recent trade;
- Suggested trading strategies such as options and trading on margin;
- Check-the-box disclosures even on complex investment products such as options;
- Misleading claims that trading is "commission free;" and
- Rewards for recruiting others to the app.

A number of these features by themselves, and certainly in combination, can reasonably be construed as recommendations under Reg BI. And they have proven to be phenomenally successful. Robinhood, for example, has experienced rapid growth in its customer base and trading volumes. From 2016 to early 2020, it grew from 1 million to 13 million accounts, and by some estimates, it now has at least 20 million users.

A critical point here is that, of course, if Reg. BI applies to a particular DEP, ***it does not mean that the DEP is illegal***. Rather, it means that in using that DEP, a broker-dealer must comply with the protective obligations of Reg. BI, including ensuring the recommendation is in the "best interest" of the client; making important disclosures about the transaction and the role of the broker; and disclosing and mitigating conflicts of interest relating to the recommendation.[37] [38]

---

36 *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

37 17 CFR § 240.15l-1(a)(1).

38 The larger broker-dealer community professed to be in favor of Reg. BI as an enhancement of consumer protections for clients that also gave broker-dealers the flexibility they claimed they needed (and claimed customers wanted). Accordingly, they should be comfortable with the application of Reg. BI to DEPs that can reasonably be considered recommendations. *See, e.g.*, SIFMA Comment Letter on Reg. BI (Aug. 7, 2018) ("SIFMA generally supports the Proposals and commends the SEC for proposing a new best interest standard under the Securities Exchange Act of 1934 ('Exchange Act'), Regulation Best Interest ('Proposed Reg BI'), that would protect retail investors while preserving retail investor choice and access to the brokerage "pay as you go" advice model.").

Finally, we caution that if the SEC cannot regulate these practices simply because they are not formally couched in terms of recommendations, then digital platforms will have a de facto "digital" exemption from the primary regulation designed to protect investors from broker-dealers pushing investment products onto their clients exclusively for their own profit. In that case, the SEC must consider adopting a new set of rules specifically addressing the threat to investors that online trading platforms and apps can pose.

B. <u>The SEC can and should ban or strengthen the regulation of payment for order flow.</u>

Another area in which the SEC can act to reduce the use of harmful DEPs is addressing the problematic practice of payment for order flow, in which broker-dealers like Robinhood sell customer orders to high frequency traders, who then execute those orders at a significant profit. PFOF is a huge source of revenue for brokers—Robinhood alone received some $687 million in PFOF in 2020,[39] and retail broker-dealers collectively received at least $2.6 billion.[40] The enormous sums of money involved in PFOF create powerful conflicts of interest for the brokers that utilize it. The most obvious is that it incentivizes brokers to route client orders to whomever gives the highest kickback, rather than to those who provide the best execution, in violation of brokers' duty. However, there is also a clear conflict of interest directly related to the use of DEPs, because PFOF "gets jacked up when trading is short term and frequent."[41] In other words, PFOF incentivizes trading apps to develop DEPs that encourage users to engage in short-termism and to trade frequently, both of which, as explained above, lead to investor harm. Banning or least strengthening the regulation of PFOF, at a minimum with more transparency and disclosure, would mitigate the harmful impact of this powerful conflict of interest.

<u>CONCLUSION</u>

We hope you find these comments helpful.

Sincerely,

Stephen Hall

---

39 *See* P. Rudegeair et al., *Robinhood's Reckoning: Facing Life After GameStop*, WALL ST. J. (Feb. 5, 2021), https://www.wsj.com/articles/robinhoods-reckoning-can-it-survive-the-gamestop-bubble-11612547759.

40 *See* A. Osipovich, *GameStop Mania Drives Scrutiny of Payments for Online Brokers*, WALL ST. J. (Feb. 4, 2021), https://www.wsj.com/articles/gamestop-mania-drives-scrutiny-of-payments-to-online-brokers-11612434601.

41 Melanie Cherdack, *Trading in the Time of Covid: A Robinhood Bromance,* 28 PIABA B.J. 159, 164 (2021).

Stephen Hall
Legal Director and Securities Specialist

Jason Grimes
Senior Counsel

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

shall@bettermarkets.com
jgrimes@bettermarkets.com
www.bettermarkets.com