Silicon Valley Start-up Robinhood - Wall Street Chaos

Why in news?

- The online trading app Robinhood became a cultural phenomenon in Silicon Valley with being one of the hottest venues in the past week's retail-trading frenzy.
- But it abruptly blocked clients from purchasing shares of some companies whose stock prices had spiked dramatically and shaken up Wall Street.

How did Robinhood evolve?

- Robinhood is a trading platform operated by American financial services company Robinhood Markets Inc.
- It is a broker-dealer registered with the United States Securities and Exchange Commission.
- The company is headquartered in Menlo Park, California.
- It was founded in April 2013 by Vladimir Tenev and Indian American Baiju Bhatt.
- Both of them are now co-chief executive officers of the company.
- Robinhood's revenue comes from interest earned on customers' cash balances, margin lending and selling order information to high-frequency traders.
- The platform is believed to have had 13 million users in 2020.
- It came with a promise to wrest the stock market away from Wall Street's traditional gatekeepers and "let the people trade."

What happened now?

- Many of the small investors were on a mission to challenge the dominance of Wall Street.
- They thus used Robinhood's free trades.
- Investors on Robinhood, who had been buying up options and shares of GameStop, a video game retailer, enlarged those bets.
- Rampant speculation on options contracts helped drive the rise of GameStop's shares from about $20 on January 12, 2021 to nearly $500 in

less than 20 days.
- Investors also began making big trades in other stocks, including AMC Entertainment.
- The trade frenzy thus morphed into a crisis.

What did the firm do?

- As the trading mania grew, the financial system's risk reduction mechanisms kicked in.
  - The mechanism is managed by obscure entities at the center of the stock market called clearinghouses.
- This forced Robinhood to find emergency cash to continue to be able to trade.
- It had to stop customers from buying a number of heavily traded stocks and draw on a more than $500 million bank line of credit.
- The company also took an emergency infusion of more than $1 billion from its existing investors.

What was the clearinghouse's role?

- One institution that tripped up Robinhood in the recent episode is a clearinghouse called the Depository Trust & Clearing Corp (DTCC).
- It is owned by its member financial institutions including Robinhood.
- The DTCC clears and settles most stock trading, essentially making sure that the money and the shares end up in the right hands.
  - Options trades are cleared by another entity.
- But the DTCC's role is more than just clerical.
- Clearinghouses are supposed to help insulate a particular market from extreme risks.
- It does this by making sure that if a single financial player goes broke, it doesn't create a contagion.
- To do its job, the DTCC requires its members to keep a cushion of cash that can be put toward stabilizing the system if needed.
- When stocks are swinging wildly or there's a flurry of trading, the size of the cushion it demands from each member, known as a margin call, can grow on short notice.
  - In the recent event, the DTCC notified its member firms that the total cushion, which was then $26 billion, needed to grow to $33.5 billion, within hours.
  - As Robinhood customers were responsible for so much trading, it was responsible for footing a significant portion of the bill.
- The DTCC's demand is not negotiable.
- A firm that cannot meet its margin call is effectively out of the stock trading

business because DTCC will not clear its trades any more.
- For a start-up like Robinhood, generating additional hundreds of millions of dollars on short notice is a big deal.

What was the response?

- The company ended up creating risk for their customers and systemic risk for the market more broadly.
- Users flooded online app stores with hurtful reviews, with some accusing Robinhood of doing the bidding of Wall Street.
- Others sued the company for the losses they sustained.
- On the other hand, even as Robinhood's actions angered existing customers, it was winning new ones.
- The Securities and Exchange Commission said that it would closely review any actions that may "disadvantage investors or otherwise unduly inhibit their ability to trade certain securities."
- While Robinhood arranged for the needed cash from its credit line and investors, it limited its customers from buying GameStop, AMC and other shares.
- Allowing its investors to sell the volatile stocks, but not buy them, reduced Robinhood's risk level and helped it meet requirements for additional cash.
- Notably, the deposit requirements had increased tenfold during the week.

What was unique with Robinhood and what impact did this create?

- The two who created the company in 2013 said from the beginning that their focus was on "democratizing finance" by making trading available to anyone.
- To do so, the company has repeatedly employed a classic Silicon Valley formula of user-friendly software, brash marketing and a disregard for existing rules and institutions.
  - E.g. online brokers had traditionally charged around $10 for every trade
  - But Robinhood said that customers of its phone app could trade for free.
  - The move drew in hordes of young investors.
- Robinhood also popularized options trading among new investors.
  - An option is generally cheaper than buying a stock outright.
  - But options trading has the potential to lead to much bigger and faster gains and losses.
  - This was why regulators and brokers have traditionally restricted trading in these financial contracts to more sophisticated traders.
- In building its business this way, the company disregarded academic research.
- It thus ignored propositions showing how frequent, frictionless trading generally does not lead to good financial outcomes for investors.

Source: The Indian Express

IAS PARLIAMENT
Information is Empowering
A Shankar IAS Academy Initiative