Rethinking Financial Securities

On the need for an alternative dispute resolution reform within the securities industry

Authored by

Perla Khattar

06MAR2022

editor@lebanonlawreview.org © 2022 HAQQ, LLC

Abstract

The internet represents a dynamic interface for the transmission of information, which only goes to show the trappings of rigid and static [legal] systems. Such was the case of the 2021 GameStop phenomenon, wherein FINRA failed to arbitrate and perform dispute resolution. It is for this reason that we need to rethink financial securities and to develop a robust alternative dispute resolution framework for the securities industry. This paper analyzes the historical evolution and inception of FINRA and its main procedures and functions. We then study FINRA's independence in light of the GameStop r/WallStreetBets. We come to the conclusion that FINRA faces a fundamental conflict of interest, being funded by the same group of businesses whose function it is to regulate. The solution would therefore to be the liberation of FINRA's arbitration department from FINRA itself, as an ad-hoc case-by-case [regular] arbitration style dispute resolution. Parties would have the right to select the arbitrator of their choice, whom would together choose a third arbitrator to preside over the tribunal.

By following this model, FINRA's arbitration would be liberated from the mercy of broker-dealer firms' money, since arbitrators would no longer depend on the fees paid by these institutions as their wages. Decisions would be more independent, fairer to the average trader, and more equitable. Such a small change could lead to the needed revolution in the securities industry, and the world could finally see the birth of a second big market: the small traders' market. People like the subscribers of WallStreetBets deserve to have a chance and deserve to receive justice when a wrong is committed by a trader-broker. This is because our proposed solution addresses a core imbalance in the conflict of interests – we see that implementing our solution would be a better way to administer justice inside the institution.

 © 2022 HAQQ, LLC.

Table of Contents

Abstract 2
Table of Contents 3
Acronym Index 4
Introduction 5
I. FINRA's Inception 7
II. FINRA's Key Roles 10
Alternative Dispute Resolution Through FINRA 12
Six-Year Eligibility Rule 13
Prefiling Consideration 13
Number and Ranking of Arbitrators 14
Initial Pre-Hearing Scheduling Telephone Conference 15
Discovery 15
Twenty-Day Exchange 15
Arbitration Briefs 16
Evidentiary Hearing 16
III. FINRA's Independence 17
Structure 18
Accountability 18
Lack Of Accountability 19
IV. The r/WallStreetBets Imbroglio 20
Background 20
GameStop Short Squeeze 21
The Robinhood Fiasco 22
Ongoing Issues with Robinhood 23
Robinhood Sets Aside $26.6 Million To Settle with Finra 24
V. Reform Through Alternate Dispute Resolution 25
Conclusion 29
Bibliography 30
Legislative Sources 30
Court Decisions and Jurisprudence 30
Secondary Sources 30

 © 2022 HAQQ, LLC.

Acronym Index

Exchange Act: Securities Exchange Act.

FAA: Federal Arbitration Act.

FINRA: The Financial Industry Regulatory Authority.

FTC: Federal Trade Commission.

IPHTC: Initial Pre-Hearing Scheduling Telephone Conference.

NASD: National Association of Securities Dealers.

NASDAQ: National Associations of Securities Dealers Automated Quotations.

NIRA: National Industry Recovery Act.

NYSE: New York Stock Exchange.

OTC: Over-the-counter markets.

Robinhood: Robinhood Financial LLC.

SEC: U.S. Securities and Exchange Commission.

SECO: SEC-Only Program.

SRO: Self-Regulatory Organization.

 © 2022 HAQQ, LLC.

Introduction

"Underdogs can accomplish just about anything when they come together around a common idea."

That's the assertion Reddit made during its 5 seconds Super Bowl 2021 advertisement, after spending the entirety of its marketing budget on the statement. What was the social media giant trying to say? Were they trying to convey a political message, or maybe some social ideation? To every watcher's surprise, Reddit was referring to the success that a bunch of internet geeks, namely r/WallStreetBets subscribers, had while joining the short squeeze of the GameStop stock option, initiated by Wall Street Hedge Fund Managers. These normal everyday people were able to drive the price of the stock from $4 to $347, amassing massive pecuniary benefits and driving big financial firms to massive losses. This fiasco led Robinhood, the application-based broker-dealer to halt the trading of GameStop on its platform, backing up Citadel Securities, a high-frequency trading firm, whose hedge fund was helping to prop-up Melvin's Capital Management's large short position. WallStreetBets subscribers were furious since the halt caused them to lose potential gains.

However, Reddit sees it differently: For the first time in our short history, the securities industry is seeing the rise of the small traders. They used to be looked at as pawns in the big chess game: they were looked at as minuscule capitals and unexperienced dealers that are easily manipulated. For the first time, small traders were able to attack the queen, by strategically participating in the game hedge funds were professionals at playing. And some would say, at manipulating.

When it comes to regulating and to bringing peace to this whole fiasco, one association is given the exclusive right to do so: The Financial Industry Regulatory Authority ("*FINRA*"). FINRA was created in 2007 in an attempt to harmonize the industry and regulate its activities

 © 2022 HAQQ, LLC.

to avoid injustice and chaos. For that reason, FINRA was given the exclusive right to arbitrate all cases that come up with its members, mainly broker-dealers. These members have to add a mandatory arbitration clause to all their contracts with customers, therefore giving FINRA the exclusive right to arbitrate their disputes.

One problem arises here: arbitrators that are trusted to resolve these cases are paid by the broker-dealers to do the job. Let us explain. FINRA receives its budget from fees paid by members, namely the broker-dealers' firms. Without this precious money, FINRA could never exist. Arbitrators are paid from these fees, meaning that one party to the dispute directly contributes to the financial wellbeing of the ultimate award issuer. This is a concern since arbitrators are less likely to strike against businesses that contribute to the existence of their job in the first place. The following leads us to a flawed justice system within an industry that is predominantly controlled by big hedge funds and broker-dealer's firms, leaving the "*underdogs*" wingless in their pursuit of success. No award has been issued when it comes to the halt in trading of the GameStop stock by Robinhood, but a significant penalty is highly unlikely given that the broker – dealer has only put aside $26 million for negotiations – a number that is minimal compared to the lost opportunities of WallStreetBets. If a FINRA arbitrator decides to side with small traders, that would lead to the potential shut down of Robinhood, losses in FINRA's revenue, and loss of wages. We see a problem that needs tending to, immediately. FINRA needs to STOP THE NEXT GAMESTOP.[1]

Therefore, here is our questioning: How did FINRA come to light and how was is founded? What are FINRA's key roles and how does it participate in resolving disputes in the securities industry? How is FINRA's independence translated through its structure, and is it truly held accountable for its action or inaction? What is r/WallStreetBets and why were they

[1] What we mean by this statement is that FINRA is unable, at this moment, to bring justice to any victim of any fiasco that happened or could happen.

 © 2022 HAQQ, LLC.

in the news? What is the GameStop short squeeze and how did it lead to the Robinhood fiasco? What is wrong with Robinhood and why is FINRA turning a blind eye to the allegations? And most importantly: **How can FINRA's arbitrators play a key role in the regulation of the securities industry and the prevention of inequalities when it comes to small traders joining the big firm's financial game?**

In this paper, we will be first going over the timeline that led to the creation of FINRA as a regulator in the securities industry. Then, we will be explaining FINRA's key roles quickly in order to stress on its job in resolving disputes through mandatory arbitration. Thirdly, we will explain the framework that makes FINRA independent and accountable (or not). Then, we will dive in the details that surround the r/WallStreetBets imbroglio by explaining its background, the short squeeze on Game Stop and the Robinhood fiasco alongside the issues related to the company. Finally, we will argument that FINRA's structure is indirectly participating in justice not being achieved through its arbitration system, since arbitrators are being paid their salary exclusively from one party to the dispute. We will provide a solution that we think will bring harmony to the industry and lead to justice through an alternative dispute resolution reform.

I. FINRA's Inception

Long before the "*Depression-era federal securities framework*," there has been a well-established tradition in the securities industry where key players in said industry collaborate to find a common ground and set forth their own standards of conduct.

In 1934, the Securities Exchange Act[2] ("*Exchange Act*") was passed and gave power to Self-regulatory Organizations ("*SRO*") such as the New York Stock Exchange ("*NSYE*") or

[2] 15 U.S.C. § 78a et seq. [1943].

 © 2022 HAQQ, LLC.

the National Association of Securities Dealers ("*NASD*")[3] to perform routine regulatory functions under the surveillance of the U.S. Securities and Exchange Commission ("*SEC*").[4]

Initially, the Exchange Act did not cover over-the-counter markets ("*OTC*"), which meant that any broker working for the OTC market would not have been regulated by an SRO. In order to rectify that, the Code of Fair Competition was approved under the National Industrial Recovery Act ("*NIRA*") and became legally binding by President Franklin D. Roosevelt's signature. However, in 1935, the Supreme Court ruled the code to be unconstitutional in *Schechter Poultry Corp. v. United States*, where it held that*: "[c]ode-making authority thus conferred is an unconstitutional delegation of legislative power."*[5]

OTC markets left without regulations led the SEC to work with the industry to convince Congress to pass the Maloney Act[6] in 1938, which added section 15A to the Exchange Act therefore allowing associations of brokers or dealers that meet the statutory requirements to register with the SEC as a voluntary national securities association; subsection (a) explains that: "*[a]n association of brokers and dealers may be registered as a national securities association pursuant to subsection (b), or as an affiliated securities association pursuant to subsection (d), under the terms and conditions hereinafter provided in this section and in accordance with the provisions of section 78s(a) of this title* (…)*."*[7] Technically, the Maloney Act's voluntary national securities associations were set to be the OTC market's equivalent of the exchange SROs.

In 1937, NASD became the first SEC approved and registered national securities association, and it became the only SRO for brokers and dealers in OTC markets.

---

[3] NASD happens to be FINRA's predecessor.
[4] SEC is the governmental regulator for securities markets.
[5] [1935] 295 U.S. 495.
[6] Stat. 1070; [1938] Pub. L. No. 75-719.
[7] § 78o-3; [2012] 15 U.S.C.

 © 2022 HAQQ, LLC.

Subsequently, in 1945, NASD required principal and employees of brokers and dealers to register with NASD, and in 1960, SEC recommended that NASD membership should be mandatory to all players in the OTC markets.

After being given power from Congress in 1964, SEC created the SEC-Only program ("*SECO*") but later abolished it and made NASD membership mandatory in 1983. SEC explained that "*a direct regulatory program was not the most efficient use of the Commission's resources and that weak links in the program regarding rulemaking and data collection could not be improved without increased expenditures. The Commission determined that the benefits of retaining the SECO Program were minimal compared to the benefits to be derived from its elimination*."

In 1971, NASD successfully created the National Association of Securities Dealers Automated Quotations ("*NASDAQ*"). However, in 1996, SEC heavily censured NASD for failing to enforce rules against NASDAQ's practices such as prices manipulation, sharing of customer information and general anticompetitive practices.

After NASDAQ members voted in 2000 for its separation from NASD, the SRO gained exchange status six years later.

Concerns about conflict of interest in SROs intensified in the market which led exchanges to become for-profit entities; for instance, the NYSE merged with the publicly traded company Archipelago.

In order to calm the market, the SEC offered seven reform options, one of which was called the hybrid model that would create a standalone SRO to which all brokers and dealers would belong, making membership mandatory. The hybrid model became a reality with the creation of FINRA in 2007 by the merger of the member regulation functions of the NASD and the NYSE Regulation.

 © 2022 HAQQ, LLC.

Specifically, FINRA was set to be a new SRO that "*would provide member firm regulation for securities firms that do business with the public in the United States*,"[8] and it would be "*responsible for rule writing, firm examination, enforcement and arbitration and mediation functions, along with all functions that were previously overseen solely by NASD, including market regulation under contract for NASDAQ*."

The creation of FINRA helped streamline broker-dealer regulatory systems and unified the set of rules that govern the securities industry in the United States of America, which ultimately assured investor protection.

FINRA is a new entity that has been around for less than 20 years. It plays a key role when it comes to the administration of justice in the securities industry since arbitration through FINRA becomes mandatory to all its members; mainly big broker-dealers' firms. In other terms, if a broker-dealer firm has an issue with a customer, the case is taken to FINRA's mandatory arbitration. Additionally, FINRA plays other roles in the securities world, which we will be discussing in the upcoming paragraph.

II. FINRA's Key Roles

FINRA was founded in 2007 and felt like a breath of fresh air to the securities industry, since the association came to fix problems that have been around for decades. Not only FINRA is the only regulator of the securities industry, but it also is the sole justice administrator for its members. This section will explain further the importance of this association.

First, FINRA likes to avoid the label of SRO and swap it for "*the largest independent regulator of securities firms doing business with the public in the United States*."

[8] Reg. 42170; [2007] 72 Fed.

 © 2022 HAQQ, LLC.

After its conception in 2007, FINRA became a front-line regulatory force that competes with SEC, a statement that is often agreed upon by broker-dealers.[9] FINRA was able to regulate 636,000 registered securities representatives, 161,000 branch offices, and 4,100 firms by the end of 2012, with a running budget of $1 billion and over 3,000 employees.

In order to better understand FINRA's key role in the securities industry, we shall examine its substantive objectives found in its Restated Certificate of Incorporation, which states the following:

(1) "*To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of federal and state securities laws;*

(2) *To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;*

(3) *To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;*

(4) *To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members*."

FINRA membership is mandatory for broker-dealers doing business with the public and have to follow the lengthy rulebook that is prepared by FINRA and governs their activities

[9] SEC has a budget of $1,3 billion, when FINRA has a budget of $1 billion. SEC has 4,000 employees approximately when FINRA has around 3,400 employees. However, SEC oversees 25,000 firms and FINRA oversees 4,100 firms.

 © 2022 HAQQ, LLC.

that relate to the securities business (such as, (but not limited to) registration, continuing education, use of fraudulent devices, firm and member conduct, best execution obligations, communications with customers and third parties, keeping books and records, money laundering laws, and transactions with customers). Not only that, but FINRA enforces all federal securities laws, its own laws,[10] and the Municipal Securities laws, which in and of itself is an SRO. Whenever FINRA finds violations, it will enforce disciplinary actions such as censures, fines, restitution to harmed third parties, suspensions, and permanent bars from the security industry.

All these roles are important for the smooth sail of operations in the securities industry but are not key. FINRA's membership comes with mandatory arbitration, meaning that all members of FINRA have to arbitrate their disputes with customers after adding a mandatory arbitration clause, through the SRO.

Alternative Dispute Resolution Through FINRA

We have understood that FINRA's general task is to register, inspect and discipline its members when infractions are registered; however, FINRA plays a key role in arbitrating all disputes that arise in the securities sector with its members. Not only that, but FINRA also provides voluntary mediation services if needed by members.

It is to be noted that all FINRA's registered members are required as per FINRA rule 13201 to submit their intra-industry disputes to FINRA's arbitration (except disputes that relate to harassment, discrimination, and retaliation statutory claims).

Customer disputes are subject to mandatory FINRA arbitration as well because every *New Account Application Contract* has a binding arbitration clause incorporated by member firms, as per the Code of Arbitration Procedure for Customer Disputes ("*the Code*").

[10] § 78o-3(b)(2); [2012] 15 U.S.C.

 © 2022 HAQQ, LLC.

Commonly, these claims would be related to breach of fiduciary duties, unsuitable investment recommendations on game-like applications, conflict of interest, professional negligence, misrepresentations, fraud, or financial abuse.

Even though the alternative dispute resolution method chosen by FINRA is arbitration, it does in fact differ from the habitual arbitration that some parties may choose to resolve their issues. In order to better understand the complexity of the matter, we are going to dive deeper in the process of filing for arbitration with FINRA within the securities industry.

Six-Year Eligibility Rule

As noted by Rule 12206 of the Code: "No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim." In other terms, the statute of limitation for securities cases is six years starting from the original purchase date.

Prefiling Consideration

When a party to a dispute bound by an arbitration clause wishes to initiate a FINRA arbitration claim, that claimant will submit an online form through FINRA's portal, joined with a statement claim in which the dispute should be explained, and the relief detailed. Unlike traditional claims submitted in the State court system or the Federal court system, FINRA's arbitration does not have strict pleading requirements. It is advised, however, to have a very persuasive Statement of Claims since it is formally the first opportunity to persuade arbitrators.

The claimant will have to pay a filing fee that is determined by the overall case amount. For example, if the claim is for an unspecified amount, the claimant is bound to pay an initial $1,575 as a filing fee, and if the claim amount is between $50,000 and $100,000, the claimant will have to pay $975.

 © 2022 HAQQ, LLC.

FINRA often offers filing fee waivers whenever a financial hardship can be proved and supporting financial documents are provided.

After paying the filing fee and filing the needed documents, the respondent will be notified and will have to respond to the claim within 45 days.

Number and Ranking of Arbitrators

The code matches the number of arbitrators to the claim amount: if the claim amount is $50,000 or less, then the arbitration panel would consist of one arbitrator and arbitration procedures would be simplified. If the claim amount is between $50,000 and $100,000, then the arbitration panel will consist of one arbitrator, unless the parties agree within the arbitration clause to a panel of three arbitrators. And if the claim is more than $100,000, or if the amount is unspecified or if the claimant does not request monetary damages, the arbitration panel will consist of three arbitrators unless the parties within the arbitration clause to a panel of one arbitrator.

When it comes to arbitration selection, it is a very important matter since the panel will serve to determine both the facts and the law, unlike a jury that only determines the facts. Arbitration selection is a difficult process, because the arbitrator pool is filled with people that have strong ties in the securities industry and have been working for the "*Gods*" of Wall Street for years. Therefore, in order to choose wisely, parties must examine the professional background and past awards rendered by a potential arbitrator, in order to determine whether that person is more favorable to an investor or a broker.

Under Rule 12403 (b)(2) of the Code, a party can request additional information on a potential arbitrator, and in that case, both parties will be sent the information promptly.

When it comes to panels of three arbitrators, FINRA will send the parties a list of 30 potential arbitrators in order to initiate the ranking process: 10 chair qualified arbitrators, 15

 © 2022 HAQQ, LLC.

public arbitrators and 10 non-public or industry-related arbitrators. The parties will be invited to strike 4 out of the 10 chair qualified arbitrators, 6 of the 15 public arbitrators, and all of the non-public arbitrators. Then, parties will rank the remainder of the arbitrators so that FINRA DR can combine both rankings to come up with the finalized panel.

Initial Pre-Hearing Scheduling Telephone Conference

The Initial Pre-Hearing Scheduling Telephone Conference ("*IPHTC*") is scheduled by FINRA as a way for the parties and the chosen panel to discuss all matters related to the case such as the calendar that includes the hearing dates and relevant deadlines for motions, discovery, briefs, and others. This session is conducted by a telephone conference call generally and can be held via videoconference on a case-by-case basis.

Discovery

As per Rule 12506 (b), the FINRA discovery guide has listed documents that are presumably discoverable and should be automatically produced in every case within 60 days that the answers are due.

In order to request additional documents from the opposing party, one should rely on rule 12507 (a): "*Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require narrative answers or fact finding. Standard interrogatories are generally not permitted in arbitration*."

As per rule 12510, depositions are generally not allowed unless it is used in order to preserve the testimony of an ill or dying person.

Twenty-Day Exchange

It is a rule that all documents and witnesses that will testify must be disclosed to the panel 20 days before the first scheduled hearing date. That rule is applied whenever there is

 © 2022 HAQQ, LLC.

"*good cause*" meaning that these documents or witnesses will be needed for rebuttal or impeachment.

Arbitration Briefs

Generally, the panel will determine if pre-hearing briefs should be filed during the IPHTC. In case the panel opted for pre-hearing briefs, a two-week period is given for optional pre-hearing briefs to be submitted before the hearing.

Evidentiary Hearing

As per Rule 12213, the evidentiary hearing takes place at a location close to the claimant's residence, unless the parties agree otherwise, or have agreed on remote arbitration (due to COVID-19 or else).

When it comes to evidence, less strict rules are used by FINRA: speculations and objections to hearsay are generally overruled and evidence is received without a chain of custody requirements. As per rule 12604, it is up to the panel to decide what evidence to accept since FINRA does not follow state and federal rules of evidence.

The panel will need to give a fair opportunity for each party to present its case, but arbitrators generally start with claimant followed by the respondent.

The parties to arbitration are entitled to attend all hearings, expert witnesses as well unless persuasive reasons lead the panel to believe the contrary.

It is to be noted that each hearing day is made out of two sessions, one in the morning and the second one in the afternoon. For a three-person panel, the total amount of fees would be $3000 per hearing day. In other terms, a five-day hearing would lead to fees amounting around $15,000. The Panel preserves the right to split fees between the parties or rule that one party should pay all of them.

© 2022 HAQQ, LLC.

After concluding all hearings, the panel will have 30 business days to publish their award that includes basic information regarding the nature of the claim, details about procedure and the amount of the final award. However, the parties preserve the right to ask for an explained award that would include details about the evidence and the application of the law to the facts. Here, the respondent has 30 days to pay the amount mentioned in the award unless a petition to vacate has been filed with the court of competent jurisdiction. In case neither is done, the respondent runs the risk of having its securities license suspended by FINRA.

If a party wishes to correct minor details such as typographical or computational errors, they should do so within 10 days from the date the award was awarded, as per Rule 12905(a)(2).

If a party wishes to confirm an award, they should do so within 1 year as per section 9 of the Federal Arbitration Act ("*FAA*").

In the upcoming section we will discuss FINRA's "independence" from the securities industry.

III. FINRA's Independence

As we have outlined before, FINRA is a non-profit organization incorporated in Delaware, meaning that the funds it needs to run are not coming from the business it is generating. FINRA's funding comes from fees paid by its members (regulatory fees, user fees, contract service fees, transparency services fees, dispute resolution fees and others), and fines whenever a member breaches a specific rule.

However, can we really say that FINRA is independent from the securities industry when its funding comes from the entities it regulates?

In order to properly answer this question, we shall look at the internal structure of FINRA and at the accountability procedure.

 © 2022 HAQQ, LLC.

Structure

When referring to itself, FINRA uses the term "*largest independent contractor*" in hopes of separating from the government, the securities industry, and SEC since these entities have very limited ability to influence FINRA.

FINRA is run by a board that comprises 24 governors, 13 public governors[11] and 10 industry representatives. In order to provide accurate representation to key players, the industry governors must include an independent dealer, an insurance affiliate governor, a floor member governor, an investment company affiliate governor, three governors from small firms, one from a medium size firm and three from large firm governors. Additionally, industry members may not outnumber public members of the nominating committee when nominating replacement governors. If the nominating committee does not nominate a specific candidate, small, medium, and large firms can petition to place that candidate on the ballot.

Accountability

Primarily, the SEC exercises its oversight on FINRA by requiring reports, especially for FINRA's role in rule creation and disciplinary actions.[12]

When it comes to new rules being enacted, FINRA files these changes with the SEC to be published in the Federal Register awaiting public comment in order to approve or disapprove the changes[13]. The SEC has the power to modify, delete or add to FINRA's proposed rules through "*notice-and-comment*" rulemaking.

---

[11] These public governors cannot have any "*material business relationship*" with a broker-dealer or any other SRO. FINRA, By-Laws of the Corporation, article I, paragraph II.

[12] § 240.15Aj-1, 17 C.F.R.

[13] § 78s(b)(1) and (b)(2), 15 U.S.C.

 © 2022 HAQQ, LLC.

Additionally, the SEC has the authority to affirm, remand or revise any sanction ordered by FINRA, that can vary from structural to governance changes.[14]

The real power that the SEC has over FINRA is the fact that it can revoke its SRO registration as a securities association under the Exchange Act; but since this measure is very drastic, the exercise of such power is rather unlikely.

Lack of Accountability

First and foremost, FINRA enjoys vast immunity when carrying out its regulatory responsibilities, an incentive so it can do its job without fear of repercussions.[15]

William A. Birdthistle, professor of law at Illinois Institute of Technology Chicago-Kent College of Law, and M. Todd Henderson, professor of law at the University of Chicago Law School, have observed the true power that FINRA holds as "*financial SROs are transforming into a 'fifth branch' of government*."

However, FINRA is not subject to accountability mechanisms like those that hold Congress, the President of the United States, or other actors of the government accountable.

Some State securities regulators find that FINRA has avoided giving them valuable information in order to avoid being labelled a state actor. The nomination of FINRA a state actor would lead to accountability, which means that so far, "*FINRA has managed to exercise governmental powers without any governmental accountability*." It is unclear in what it would legally take to name FINRA a state actor subject to constitutional claims.

[14] § 78s(e), 15 U.S.C.
[15] [2011] 2d. Cir 637 F.3d 112.

 © 2022 HAQQ, LLC.

IV. The r/WallStreetBets Imbroglio

On January 12, 2021, the price of the GameStop stock was $20 when the market closed since hedge funds were short squeezing it. Small traders joined the game and were able to make the price jump over 15 times, resulting in a price of $500. This section will explain the details of what happened and how FINRA could avoid future problems like these.

Background

As per the definition given by the Georgia Institute of Technology, r/WallStreetBets ("*WallStreetBets*") is a "*subreddit devoted to irreverent memes and high-risk option trading*." The Subreddit combines over 10 million subscribers where small traders discuss the stock market and options trading[16] in a meme fashion that is recognized within the Reddit landscape. WallStreetBets was founded by Jaime Rogozinski in 2012 with the purpose of sharing "*high-risk investing or trading ideas*."

WallStreetBets subscribers are known for their tendency to buy cheap options nearing expiration, and are usually around $1, betting on the speculation that their price might go up. Options are sold in batches of 100 contracts, meaning that a subscriber wishing to buy a cheap option would have to make a $100 investment, rendering the transaction riskier. This community is known for its high-risk trading and sometimes "*inappropriate behavior.*" The popularity of the community grew with the increase of no-commission brokers and online mobile trading like Robinhood.

[16] Options are contracts that give the owner the right to buy or sell an asset at an agreed upon price, called the strike price, within a specified time period. We differentiate between call contract that gives the holder the right to buy the asset at the agreed upon price and put options that give the holder the right to sell the asset at the agreed upon price. In simpler language, if the price of an asset is going up, then buy calls, and if the price of the asset is going down, then buy puts.

 © 2022 HAQQ, LLC.

Most importantly, WallStreetBets has been notable in playing a major role in the GameStop short squeeze that led to massive losses by major U.S. firms and short sellers in early 2021.

GameStop Short Squeeze

On January 22, 2021, Citron Research predicted that the value of the GameStop stock would decrease. This information led users of WallStreetBets to initiate a short squeeze on the stock raising its price by more than 600% in under 4 days. In the securities industry, a short squeeze is "*a rapid increase in the price of a stock owing primarily to an excess of short selling of a stock rather than underlying fundamentals. A short squeeze occurs when there is a lack of supply and an excess of demand for the stock due to short sellers having to buy stocks to cover their short positions*."

The interest in the stock was mainly generated by a series of posts on the subreddit provided by "*u/DeepFuckingValue*." To exacerbate matters, and after the GameStop stock closed up 92.7% on Tuesday, technology mogul Elon Musk tweeted a link to the subreddit, bringing more traffic to the page.

Following the aftermath, Discord banned the WallStreetBets server for "*hateful and discriminatory content*" while company denied that the ban was related to the ongoing squeeze.

Within one week of the squeeze, the subreddit gained 2.4 million new subscribers, when it took them exactly 9 years to reach that number of subscribers previously. The impact was so important that Reddit ran a 5-second commercial during the Super Bowl LV glorifying and celebrating WallStreetBets stating that: "*underdogs can accomplish just about anything when we come together around a common area*."

For the first time in history, these "underdogs" were able to play the game of big hedge fun, after finding an opportunity, marketing it and creating massive financial gains.

 © 2022 HAQQ, LLC.

The Robinhood Fiasco

The short squeeze did not only affect GameStop, since WallStreetBets did also heavily trade AMC, BlackBerry Limited, Nokia and Koss Corporation.

On January 28, 2021, many broker-dealers such as Robinhood Financial LLC ("*Robinhood*"), TD Ameritrade, Webull and E-Trade restricted the trading of all the heavily shorted stocks from their online platforms and restricted their customers from buying stocks or options. After the backlash, Robinhood stated that the restrictions that were put in place were due to clearing houses raising the collateral that is required to execute the trade of highly volatile stocks.

This decision led to incalculable losses, and outrage within the WallStreetBets community, which led to a campaign against Robinhood decreasing their rating on both iOS and Android application stores to one star on January 28, 2021. Naturally, class-action lawsuits were filed against Robinhood for halting trading, and we were able to count more than 30. One lawsuit was filed in the Southern District of New York claiming that Robinhood "*purposefully, willfully, and knowingly removing the stock "GME" from its trading platform in the midst of an unprecedented stock rise thereby deprived retail investors of the ability to invest in the open-market and manipulating the open-market*." Some clients used the world's first robot lawyer "*www.donotpay.com*" to sue Robinhood by signing-up to the website.

Going back to the basics, Robinhood is a securities and brokerage firm regulated by SEC, naturally a member of FINRA and bound by its laws. However, the chief executive of Robinhood, Vlad Tenev, is not licensed with FINRA. As per FINRA's rule 1200, "*you must be registered with FINRA if you're engaged in the securities business of your firm, which includes salespersons, branch managers, department supervisors, partners, officers, and directors*," in other terms, FINRA requires the CEO of a company to be registered if that CEO

 © 2022 HAQQ, LLC.

is engaging hand on hand in the securities business. In fact, Vlad Tenev happens to be the CEO of the holding and parent company of Robinhood Financial LLC, meaning that this requirement *may* not apply, but it does not mean that Robinhood's structure is not coming under greater scrutiny after the key role that the company played in the r/WallStreetBets fiasco and the GameStop short squeeze accordingly.

Texas Senator Ted Cruz and New York Representative Alexandria Ocasio Cortez agreed, unconventionally, on the fact that Robinhood's freeze on GameStop buys was "*unacceptable*" and therefore called for congressional hearings, as soon as possible. As for Massachusetts's Senator Elizabeth Warren, she asked for explanations on the potential conflict of interest since Robinhood's largest market maker is Citadel Securities, a high-frequency trading firm, whose hedge fund was helping to prop-up Melvin's Capital Management's large short position being attacked by the WallStreetBets.

Financially speaking, the monetary risk of exposure of all pawns in the trading system increases when trading volumes of highly volatile stocks soars. In order to prevent a liquidity crisis that has the potential to bring the whole trading system down, key players would ask their counterparties to post additional capital to hedge the risk. Had that been done during the capital calls on credit-default swaps of 2008, the financial crisis *could* have been avoided.

Ongoing Issues with Robinhood

Going down memory lane, on December 16, 2020, Robinhood had actually faced regulatory scrutiny. A lawsuit was filed by one of the most active regulators in the United States of America, Massachusetts's securities enforcers alleging: "*1) aggressive tactics to attract new, often inexperienced, investors; 2) failure to implement policies and procedures reasonably designed to prevent and respond to outages and disruptions on its trading platform; 3) use of strategies such as gamification to encourage and entice continuous and repetitive use*

 © 2022 HAQQ, LLC.

of its trading applications; 4) failure to follow its own written supervisory procedures regarding the approval of options trading; and 5) breach of the fiduciary conduct standard." Robinhood is still fighting the lawsuit that found its roots in the gamification of the trading experience on the application, the free stock offers proposed by the broker, and the cartoon confetti showers that are shown on the screen as soon as a trade is complete. The next day, SEC settled with Robinhood by enforcing a $65 million fine and a censure. In the same month, FINRA enforced an action against Robinhood, where the broker had to pay a $1.25 million fine.

Robinhood Sets Aside $26.6 Million To Settle with FINRA

Warren Buffer was correct: "*It takes 20 years to build a reputation and 5 minutes to ruin it."* Things are not going well with Robinhood. After GameStop's fiasco, the reputable company *Fortune* did a simple survey with 2,336 U.S. adults, including 1,378 investors and 238 Robinhood account holders to study the impact of the imbroglio on the broker-dealer's business. *Fortune* stated that the study has a 3 percent point margin of error. The results of the survey were shocking and proved that Robinhood's business is heavily impacted by the January halt of trading: 56% of current Robinhood account holders are considering leaving the platform permanently, 40% will not leave the platform, and shockingly, 4% have left already as a result of the halting.

On February 26, Robinhood (Specifically Robinhood Financial and Robinhood Securities) disclosed through an SEC filing that they are negotiating with FINRA, state regulators and SEC. Robinhood disclosed that it accrued a minimum of $26.6 million as a settlement payment. These investigations are mainly centered around the GameStop fiasco and other ongoing issues such as how the application displays cash and buying power to its customers. The Broker-dealer expects that if negotiations flourish, settlement will involve charges of violations of FINRA rules, customer restitution, a censure, a fine and a compliance

 © 2022 HAQQ, LLC.

consultant. Robinhood added that "*Due to the very preliminary nature of all of these proceedings, we are unable at this time to estimate the likelihood or magnitude of any possible losses related to these matters*."

A settlement of $26.6 million is incredibly low, since it is not adequate to the loss of opportunity that the halt had on WallStreetBets traders. In the next section, we will explain why this specific fact causes a big problem that needs tending to.

V. Reform Through Alternate Dispute Resolution

How can a regulator be just and fair with the entities they regulate when these entities are the sole financial providers on the books? In other terms, if FINRA gets all its operation money from Wall Street Security firms, how can the average investor be sure that regulation is going to be impeccable?

In order to prove our point, we are going to be laying down some financial facts:

Robinhood charges their customer the fee imposed by FINRA on all brokerage firms: the fee is $0.000119 per share (equity sale) and $0.002 per contract (options sale). This fee is like a royalty that applies to each and every transaction that happens through the broker. This fee, even though it looks like its paid by the customer, is in fact taken out of the monetary gains that Robinhood makes. Therefore, the fee is being paid out of Robinhood's books, as a business expense.

In FINRA's 2021 budget, cash flow sources are detailed as follows: $541.8 million from regulatory fees, $287.5 million from user fees, $94.9 million from contract services fees, $924.2 million from total operating revenues, $21.3 million from interest and dividend income, and $187.5 million from potential reserves. These numbers clearly prove that FINRA's income is mainly sources from the broker-dealers it has to regulate. In other terms, similar to

 © 2022 HAQQ, LLC.

Robinhood, all other brokers on the market will have their own special formula that will make the transfer of that fee possible to FINRA.

However, in the same exact budget, FINRA allocated $47.1 million to dispute resolution, mainly arbitration. This amount is incredibly low compared to the $1133 million total cash flow that FINRA is operating with. FINRA, whose job is to resolve issues in the securities market, spends more time regulating than litigating. It is almost as if FINRA wants to turn a blind eye to what could potentially be happening in the market, like a halt in trading by a big broker when small traders decide to join an unjust short squeeze. It almost looks as if FINRA does not want to see the fraudulent activities that happen on a day-to-day basis by the brokers that finance its existence.

Put in plain English, that's how we see it: FINRA gets a lot of money from broker-dealers. FINRA has the job to regulate these same exact broker-dealers. FINRA spends a little amount of money on dispute resolution. FINRA cannot be transparent and judge these broker-dealers when its existence is contingent on their payments.

Let's contrast FINRA, the non-governmental organization, with the Federal Trade Commission ("*FTC*"), a governmental organization. The FTC has the mission of "*protecting consumers and competition by preventing anticompetitive, deceptive, and unfair business practices through law enforcement, advocacy, and education without unduly burdening legitimate business activity*." The FTC gets its budget from the United States Government and presents no conflict of interest with the entities it has to regulate.

You may be asking, why is this even relevant? Well, similar to FINRA, the FTC has the job of regulating its own industry and sanctioning when wrongs are being committed. But, unlike FINRA, the FTC does not have any sward being wielded at its throat at any given

 © 2022 HAQQ, LLC.

moment: if FINRA sanctions a broker-dealer, that's a lot of money disappearing from FINRA's yearly books and potentially a lot of jobs being lost.

Here's the hypothetical: FINRA wants to sanction Robinhood for halting trading when the GameStop fiasco happened and for baking up hedge funds instead of small traders. If FINRA rules for the small traders in its mandatory arbitration process, and strikes against Robinhood heavily, FINRA will be losing money.

The events that happened this past January may not be of a gravity that could lead to a permanent halt in Robinhood's business, but if something like that were happen again, why would FINRA issue a harsh decision against its breadwinner? Why would FINRA decide to side with small investors whose contributions are small in front of the millions that broker-dealers pay FINRA every year? Why would a FINRA arbitrator issue a decision that could potentially lead them to lose their job if resources are cut down?

How can the administration of justice be independent from outside scheming when the arbitrator deciding on the case is being paid to do the job by one of the parties? How can small investors have trust in the securities industry if they know that the people being paid to protect them from market manipulation are paid by market manipulators? Lady Justicia wears a blindfold on her eyes while holding a scale in her hand to symbolize the independence of justice. Is justice having an arbitrator, with mandatory jurisdiction, deciding on cases that are filed mainly by the small investors against *the Big-FINRA-Fee-Payers*?

We are not saying that FINRA's arbitrators are denying justice; our issue is that numbers do not add up. We discussed previously that Robinhood set aside $26.6 million dollars to negotiate with FINRA; this is a small amount compared to the losses caused by the halt in trading. **Our argument is that an entity whose job is to regulate a group of businesses cannot be paid by the same businesses to do the job.** This represents a conflict of interest.

 © 2022 HAQQ, LLC.

Therefore, what is the solution?

FINRA's arbitration department should be liberated from FINRA, just like regular arbitration: we suggest for arbitration to remain mandatory in the securities sector, under FINRA's arch because the flexibility that is offered by this alternative dispute resolution method is key in a world where every second matters. However, we believe that parties should have the right to select arbitrators from outside of FINRA, just like any regular arbitration.

These arbitrators would be paid on a case-by-case basis, either by both parties equally, or by the losing party (this detail should be decided by the arbitration clause itself found in the binding contract the parties enter into).

As for the selection process, we see that each party should have the right to select one arbitrator of their choice. Then, the two chosen arbitrators would decide on a third arbitrator to preside the arbitral tribunal.

By following this model, FINRA's arbitration would be liberated from the mercy of broker-dealer firms' money, since arbitrators would no longer depend on the fees paid by these institutions as their wages. Decisions would be more independent, fairer to the average trader, and more equitable. Such a small change could lead to the needed revolution in the securities industry, and the world could finally see the birth of a second big market: the small traders' market. People like the subscribers of WallStreetBets deserve to have a chance and deserve to receive justice when a wrong is committed by a trader-broker. We have no statistics or market study to back up this claim, but we can assure that the GameStop fiasco is not going to be the last time the world hears about WallStreetBets traders intercepting short squeeze plans of *Big Financial Firms*. And since FINRA should find a way to stop another imbroglio, we see that implementing a better way to administer justice inside the institution is key.

 © 2022 HAQQ, LLC.

Conclusion

We will be ending this paper the way we started it, by quoting the advertisement that Reddit aired during the 2021 Super Bowl: "***Powerful things happen when people rally around something they really care about***." What WallStreetBets subscribers were able to do is phenomenal; something never seen before. That something won't be the last achievement the subreddit is going to have. We are going to be seeing more and more of it as years go by.

FINRA is a somewhat recent association, with room for improvement. The things that it has been able to achieve are recognized by all since it did fill a gap in the market. However, we do believe that "*good enough isn't good enough if it can be better, and better isn't good enough if it can be best*!"[17]

This paper proposed to reform the way FINRA administers justice: arbitrators should be paid on a case-by-case basis, by both parties or one of the parties if the arbitration clause states so. This reform will guarantee the independence of verdict issuers from outside influence related to the continuity of wages and the persistence of the job.

In 2007, it was the market's concern around conflict of interest in SROs that led the SEC to offer reform options, one of which was the hybrid model that would create the standalone SRO, FINRA, to which all brokers and dealers belong. We have explained why we believe that a clear conflict of interest exists inside FINRA today, since arbitrators are being paid by one party they arbitrate. Therefore, what would it take to see a second reform in the securities industry? Is it maybe the second GameStop? Only time will tell.

[17] Quote by Rick Rigsby.

 © 2022 HAQQ, LLC.

Bibliography

Legislative Sources

[1938] Pub. L. No. 75-719, 52 Stat. 1070.

[2012] 15 U.S.C. § 78o-3.

[2007] 72 Fed. Reg. 42170.

[2012] 15 U.S.C. § 78o-3(b)(2).

17 C.F.R. § 240.15Aj-1.

15 U.S.C. § 78s(b)(1) and (b)(2).

15 U.S.C. § 78s(e).

Court Decisions and Jurisprudence

[1935] 295 U.S. 495. *Schechter Poultry Corp. v. United States*.

[2011] 2d. Cir. 637 F.3d 112, *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*.

Secondary Sources

Birdthistle, William A., Henderson, Todd M. [2013]. *Becoming a Fifth Branch*. Cornell Law Review 99.

Boylston, Christian J., Palacios, Beatriz E., Tassev, Plamen T. [2021]. *WallStreetBets: Positions or Ban.* Georgia Institute of Technology.

Deshmukh, Michael. [2014]. *Is FINRA a State Actor? A Question That Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It*. Vanderbilt Law Review 67, no. 4.

 © 2022 HAQQ, LLC.

Durr, Kenneth, Colby, Robert [2021]. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry*. Sechistorical. http://www.sechistorical.org/museum/galleries/sro.

FINRA. Arbitration *Overview*. FINRA. http://www.finra.org/ArbitrationAndMediation/Arbitration/Overview.

FINRA. *FINRA Rules*. http://www.finra.org/Industry/Regulation/FINRARules.

Fulton, Wallace H. [1946]. *The Securities Acts Amendment and the Investment Banking Community*. NASD News. [PDF]. http://3197d6d14b5f19f2f4405e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1946_0201_NASDNews.pdf

Furgison, Jon. [2020]. *FINRA Arbitration: The basics of arbitration of disputes with broker-dealers and financial advisors, plus some pro tips from an industry insider*. Advocate Magazine. https://www.advocatemagazine.com/article/2020-november/finra-arbitration.

Hsu, Tiffany. [2021]. *Reddit's 5-Second Ad Was an Unlikely Super Bowl Winner*. The New York Times. https://www.nytimes.com/2021/02/08/business/media/reddit-super-bowl-ad.html

Lambert, Lance. [2021]. *Robinhood's brand is severely damaged: 56% of account holders are considering leaving the app*. Fortune. https://fortune.com/2021/02/19/robinhood-brand-damage-gamestop-hedge-funds-wallstreetbets-reddit-stocks-gme-amc

Massa, Annie; et al. [2021]. *Robinhood Fallout Sweeps Market After $1 Billion Lifeline*. Bloomberg. https://www.bloomberg.com/news/articles/2021-01-29/for-robinhood-a-dash-for-cash-after-traders-took-on-wall-street

 © 2022 HAQQ, LLC.

McGowan, John D. [1978]. *The NASD: Origins, Recent Developments, and Future Goals*. [PDF]. http://3197d6d14b5f19f2f4405e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1974_0801_NASDOriginsT.pdf

MSRB. *Market* Regulation. MSRB. http://www.msrb.org/AboutMSRB/Programs/MarketRegulation.aspx

National Futures Association. *The Value of Building Strong Relationships*. NFA. http://www.nfa.futures.org/news/newsLetterArticle.asp?ArticleID=535.

Owens, Hugh F. [1965]. *The Securities Acts Amendment and the Investment Banking Community*. SEC. [PDF]. https://www.sec.gov/news/speech/1965/040865owens.pdf

Peters, Jay. [2021]. *Google salvaged Robinhood's one-star rating by deleting nearly 100,000 negative reviews*. The Verge. https://www.theverge.com/2021/1/28/22255245/google-deleting-bad-robinhood-reviews-play-store

Potter, Thomas III. [2020]. *Robinhood to Settle Options-related investigations*. Jdsupra. https://www.jdsupra.com/legalnews/robinhood-to-settle-options-related-8926392/

Prentice, Chris, Schroeder, Pete. [2021]. *Famed GameStop Bull 'Roaring Kitty' Is a Massachusetts Financial Advisor*.

S. Dent. [2021]. *Reddit celebrated WallStreetBets in a five-second Super Bowl ad*. Engadget. https://www.engadget.com/reddit-did-a-five-second-superbowl-ad-poking-at-robinhood-094727837.html

 © 2022 HAQQ, LLC.

SEC. [1996]. *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market*. Sechistorical. http://www.sechistorical.org/collection/papers/1990/1996_0808_SECNASD_1.pdf

SEC. [2007]. *SEC Gives Regulatory Approval for NASD and NYSE Consolidation*. SEC.GOV. http://www.sec.gov/news/press/2007/2007-151.htm.

Smythe, Marianne K. [1984]. *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*. North Carolina Law Review 62.

 © 2022 HAQQ, LLC.