UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

CASE NO. 21-2989-MDL-ALTONAGA/Torres

In re:

JANUARY 2021 SHORT SQUEEZE TRADING LITIGATION
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This Document Relates to the Securities Tranche

ORDER

THIS CAUSE came before the Court on Defendants, Robinhood Markets, Inc.; Robinhood Financial, LLC; and Robinhood Securities, LLC's (collectively, "Robinhood['s]") Motion to Dismiss the Federal Securities Tranche Complaint [ECF No. 449], filed on January 7, 2022. Plaintiffs filed a Response [ECF No. 454], to which Defendants filed a Reply [ECF No. 455]. The Court has carefully considered the Consolidated Class Action Complaint ("CCAC") [ECF No. 446], the parties' written submissions, the record, and applicable law. For the following reasons, the Motion is granted in part and denied in part.

INTRODUCTION

In January 2021, market volatility prompted regulators to raise deposit requirements for clearing brokers, including Robinhood, to ensure that they could cover the costs of unexecuted trades. Robinhood could not afford the new deposit requirements and sought another way to appease regulators. It succeeded after regulators agreed to waive the deposit requirements so long as Robinhood restricted its customers' access to certain stocks.

What followed is disputed, but Plaintiffs characterize it as market manipulation. While Robinhood agreed to restrict access to certain stocks, it did not want knowledge of its lack of liquidity to become widespread because such information might undermine Robinhood's credibility with customers and investors alike. To divert the public's attention away from Robinhood's lack of liquidity, Robinhood blamed market volatility for its restrictions and vehemently denied any trouble with its own liquidity.

Now, Robinhood asks the Court to dismiss the pleading setting forth Plaintiffs' market manipulation theory. It relies on the unconventional nature of the theory, among other reasons, as a basis for dismissal. Plaintiffs, in contrast, argue that irrespective of the theory's unconventional nature, it is sufficient that Robinhood's alleged actions artificially affected supply and demand, thereby depriving investors of an accurate picture of the market. The Court agrees with Plaintiffs and explains further below.

BACKGROUND

I. Robinhood's History

In the wake of the Occupy Wall Street protests, Vlad Tenev and Baiju Bhatt came up with an idea to democratize finance: Robinhood. (*See* CCAC ¶ 31). The two Robinhood founders set out to create an application-based trading platform that would give anyone with a smart phone access to public markets. (*See id.* ¶ 2). Its users joined a growing trend of lay traders, also known as retail investors, who use online brokerage firms to trade securities. (*See id.* ¶¶ 2, 5, 8, 35, 37). With Robinhood leading the pack, the online retail trading industry exploded, bringing markets to consumers' fingertips. (*See id.* ¶ 35).

Democratizing finance proved to be extremely lucrative. Robinhood earned millions of dollars from a system called "payment for order flow" ("PFOF"). (*Id.* ¶ 32 (quotation marks omitted)). PFOF is a revenue model whereby customers bid on securities through their brokerage platform, but instead of taking the bid directly to an exchange, like the New York Stock Exchange (NYSE) or NASDAQ, the broker brings the bid to a market maker. (*See id.*). Market makers stand ready to buy or sell securities but typically respond to the bid with an ask price that, if accepted, decreases or increases the return for the customer. (*See* Robinhood Fin., LLC, Securities Act Release No. 10906, Exchange Act Release No. 90694, 2020 WL 7482170, at *3 (Dec. 17, 2020)).[1] High volume trading makes PFOF extremely lucrative because market makers compensate brokers for routing their customers' orders to them — hence "payment for order flow." (*See* CCAC ¶¶ 32, 49). For example, in 2020, Citadel Securities, a market maker, paid Robinhood $326 million, up from $80.5 million in 2019. (*See id.* ¶ 49).

Market makers also route the trading data from Robinhood's platform to high-frequency traders ("HFTs"). (*See id.* ¶¶ 3, 33 n.9). HFTs use algorithms that automatically trade based on existing trends. (*See id.* ¶ 30 n.5). Upon receiving bid data from market makers, HFTs front-run the bid, anticipating the effect of the bid on the security's price before the transaction is consummated. (*See id.* ¶¶ 3, 30 n.5, 31, 34).

Robinhood's popularity also reflected the growing trend of retail trading during the COVID-19 pandemic. (*See id.* ¶ 35). Retail investors convened on social media sites, like Reddit and Stockwit, "to discuss investment strategy and the merits of trading in particular stocks." (*Id.*).

By December 2020, Robinhood claimed "to have opened nearly 50% of all retail brokerage accounts in the past five years" and had a total of 12.5 million online accounts. (*Id.* ¶ 5 (footnote call number omitted)). Before Robinhood would go on to add another 3 million accounts in January 2021, the press reported in December that Robinhood had selected Goldman Sachs to manage Robinhood's initial public offering in 2021. (*See id.* ¶¶ 5, 39 (citation omitted)).

[1] Federal Rule of Evidence 201(b)(2) allows the Court to take judicial notice of the Securities & Exchange Commission's ("SEC['s]") cease-and-desist order, as well as other SEC publications.

II. The Short-Squeeze Crisis

Several prominent investors planted seeds of crisis in November 2020, when they purchased shares in what became known as "meme stocks" or the "Affected Stocks."[2] (*Id.* ¶¶ 4, 40 (quotation marks omitted)). The investments pitted these well-known investors against several hedge funds that took short positions in the meme stocks. (*See id.* ¶¶ 35, 40, 43). Melvin Capital was one such hedge fund that took a short position in GameStop. (*See id.* ¶ 43).

Short positions derive from a belief that the price of a security is overvalued and will eventually fall. To capitalize on this hunch, investors, known as short sellers, purchase a "short." (*See id.* ¶¶ 40–43, 70–72). The mechanics of a short are as follows: (1) an investor identifies a security that it wants to short, such as a stock, and deposits capital, or margin, into a brokerage account to cover the risk of loss associated with the short; (2) a lender loans the security to the investor; (3) upon receiving the borrowed security, the investor sells it for a high price; and (4) the investor waits until the anticipated drop in share price occurs and then repurchases the stock for less than she sold it. (*See* Jan. 26, 2022 Order [ECF No. 453] 3 [hereinafter "Robinhood Tranche Order"]).

Short positions may bear substantial risk. (*See, e.g.*, CCAC ¶¶ 41–43). If the stock price rises a little, the short seller loses money. (*See, e.g.*, *id.* ¶ 41). If the stock price rises a lot, the broker may issue a margin call, which requires that the short seller deposit more capital into its brokerage account to minimize the risk of the rising stock. (*See id.* ¶¶ 38, 38 n.18, 42; *see also* SEC, *Staff Report on Equity and Options Market Structure Conditions in Early 2021*, at 26 (Oct. 28, 2021), https://www.sec.gov/files/staff-report-equity-options-market-struction-conditions-

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[2] The "Affected Stocks" include AMC Entertainment Holdings, Inc. ("AMC"); Bed Bath & Beyond Inc. ("BBBY"); BlackBerry Ltd. ("BB"); Express Inc. ("EXPR"); GameStop Corp. ("GME"); Koss Corp. ("KOSS"); Tootsie Roll Industries Inc. ("TR"); and American Depositary Shares of foreign-issuers Nokia ("NOK") and trivago N.V ("TRVG"). (*See* CCAC ¶¶ 1, 128).

early-2021.pdf ("SEC Staff Report"))). If the stock price continues to rise with no end in sight, short sellers will capitulate and purchase the stock to cover their losses. (*See* CCAC ¶ 43). This pattern results in a vicious cycle known as a short squeeze: (1) a stock's price rises; (2) short sellers purchase the stock to cover their losses; (3) short sellers' capitulation causes the stock price to rise further; (4) and other short sellers are forced to purchase the stock; (5) sending the stock price rising even further, and so on.

After noticing the contest between hedge funds and other investors, retail investors rallied against the hedge funds. (*See id.* ¶¶ 40–41). Using a sub-Reddit thread called WallStreetBets as a collective action platform, retail investors purchased millions of shares of GME, sending the stock price soaring. (*See id.* ¶¶ 35, 40–43).

GME closed at $43.03 on January 21, 2021. (*See id.* ¶ 41). Twenty-four hours later, it closed at $65.01. (*See id.*). By January 27, the share price reached $347.51. (*See id.* ¶ 121). The skyrocketing share price created a short squeeze, which forced hedge funds, like Melvin Capital, to take short positions in GME to quickly cover their losses. (*See id.* ¶ 43). Despite receiving two loans for $750 million and $2 billion each, Melvin Capital had to close out its short position. (*See id.*).

III. Robinhood's Reckoning: January 28 – February 2, 2021

Hedge funds were not alone. The short squeeze forced Robinhood to reckon with its newfound popularity. Specifically, the short squeeze created volatile market conditions that forced the National Securities Clearing Corporation ("NSCC") to impose higher collateral requirements on Robinhood (*see id.* ¶ 58) — requirements that Robinhood could not meet.

Before delving into how the collateral requirements affected Robinhood, it is worth pausing to explain the NSCC's role in this matter. The NSCC is a national clearing agency regulated by

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