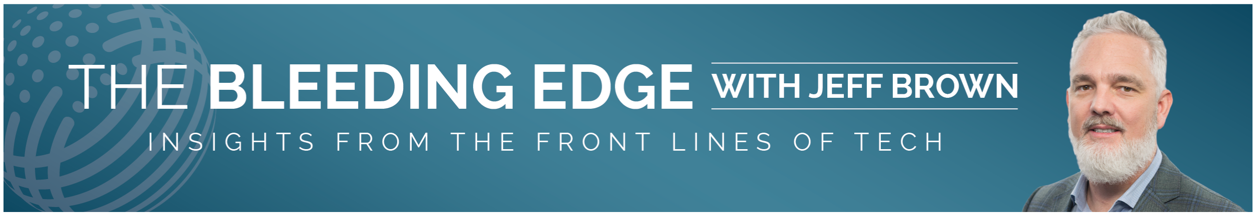

Dear Reader,
Last Thursday, we crawled down the rabbit hole on the extraordinary GameStop (GME) situation. I told you all about the efforts to ban or censor the merry band of retail investors who recognized a major market distortion and traded in hopes of a profit.

At least, that's what they *tried* to do. But these events have become even more interesting and bizarre than they were a few days ago…

The distortion was the massive levels of naked short selling of GameStop's stock by hedge funds. This was all done to drive down the share price and make a profit.

Naked short selling is not supposed to be possible. Still, it happens all the time. It happens when the total short position is larger than the total number of shares available to short. And that's exactly what happened with GameStop.

A large number of retail investors identified this massive short position and drove up the shares in GameStop to levels that almost brought down the hedge fund Melvin Capital. Two other prominent hedge funds, Citadel and Point72, had to bail it out.

And brokerage houses were overwhelmed by all the buying and selling activity on GameStop. One in particular was caught way off guard: Robinhood.
What happened next is hard to believe

Robinhood was lending out shares of GameStop and other highly shorted companies to hedge funds. Robinhood generated lending fees by doing so. It also allowed – arguably encouraged – the retail users of its platform to trade stocks and options on margin.

But there was so much activity around GameStop that Robinhood could no longer meet its capital requirements from a regulatory perspective. It had to quickly raise additional private capital to shore up its balance sheet and provide enough capital to clearinghouses to avoid getting into trouble… or something much worse.

More specifically, it drew down on credit lines of $500–600 million and raised more than $1 billion in emergency funding. The most ironic part was that it did so hours after stating that it had no liquidity problem.

But in order to stop its increasingly large capital requirements from growing even larger, Robinhood suspended trading on several shorted stocks like GameStop.
And it didn’t just suspend trading. Robinhood actually started selling its users’ positions at its own discretion. Many traders

using Robinhood reported having their shares sold without their permission.

That's not a typo. Users profiting from GameStop were closed out of their positions – without their consent – at rapidly declining prices in GameStop. This was done so Robinhood could shore up its own business.

And it resulted in the loss of more than $1 billion in profits for retail investors. Of course, it saved hedge funds an equivalent amount of bleeding.
Robinhood is certainly an inappropriate name for the online brokerage. I propose renaming the company "Robbing the Neighborhood."

Robinhood was supposed to let regular investors do "commission-free trading."
But the company did exactly the opposite. The platform is not commission-free. And apparently the company can trade our stocks in a way that benefits Robinhood and its customers… and hurts its users.

I use that language intentionally. Robinhood's "users" use the brokerage to trade and invest. Robinhood's "customers" are actually the hedge funds that pay Robinhood for order flow. Robinhood's largest customer is Citadel. More than half of the orders that Robinhood users place are routed through it.

The absurdity of this situation is baffling.
Robinhood is the online broker equivalent of what Facebook is to social media.

Robinhood takes users' data – their order flow – and sells it to the highest bidders.

What do Robinhood users receive in return? "Free" trading. But Robinhood users *do* in fact pay for trading through suboptimal order execution. That results in more profits for Robinhood's real customers – the hedge funds – and fewer profits for Robinhood's users.

And politicians are now looking at retail investors to determine if they are manipulating the markets. I predict that this will end in new regulatory changes to "protect" us retail investors from any speculative behavior.

And, of course, the hedge funds are crying foul due to the sting of losing billions. But the real focus should be on the hedge fund activity and naked short selling.

I doubt that will happen. After all, the new U.S. Treasury Secretary, Janet Yellen, received $810,000 of speaking fees from none other than Citadel over the last couple of years.
I suspect that the old saying will ring true…

"Don't bite the hand that feeds you."