GameStop and Compliance

If anyone needed any evidence we truly are in a brave new world, the events of the past week in the stock market made clear we are anything but. If you thought that the failure of the Trump-led insurrection against the US Democracy would be the end of insanity, you were sadly mistaken. This past week saw perhaps the wildest swing in certain stocks since the Panic of 1907 and that event led directly to the creation of the US Federal Reserve Bank.

As Jed Gardner, Senior Vice President at Linedata Technology Services, said about the Coronavirus health crisis and its impact on business, "we have moved from disaster recovery to business continuity to business as usual during the time of Coronavirus. He explained that risk managers, compliance professionals and business executives now have to plan for the unknown unknowns in their business plans and risk management strategies." This white paper will explore the GameStop Corporation phenomenon, focusing on the lessons for the compliance professional.

I. What was the GameStop Phenomenon?

According to Matt Phillips, writing in the New York Times (NYT), GameStop is a "video game retailer whose stock is suddenly the darling of day traders who are putting the squeeze on Wall Street's big players. The stakes are enormous: The surge in trading drove GameStop's value up by more than $10 billion on Wednesday alone. On Thursday, as several trading platforms temporarily placed restrictions on the stock, the shares slid 44 percent, only to soar again on Friday after the trading restrictions were eased. Exactly why GameStop's value — on paper, at least — has rocketed to stratospheric levels has to do with a mix of traditional investing, rampant enthusiasm, stock market mechanics and the belief that anyone with a Robinhood account can meme a fortune into existence."

The maneuver switch started the volatility is a short squeeze, with investors "betting on which way a stock will go — up or down. These bets are placed by buying the shares themselves, or stock options". Investors who bet against a stock are called "shorts"; which in GameStop's case, included least two big hedge funds. The action of shorting a stock essentially means borrowing shares from a broker and selling them, with the agreement they will then return the shares at a later date or time. If the price falls, you can then buy back the shares and pocket the difference.

Does this sound like manipulation? In some cases, it is "but shorting a stock is risky — if the price rises, you can lose big." Your organization can make a bad bet. But someone or some group can push back from the other side to drive up the stock price by purchasing many shares. "This is the squeeze. Shorts have to close their position — that is, buy up the shares they owe their brokers and return them. This demand kicks the stock higher, and a short who acts too late could be ruined."

A classic example of this to and fro by financial behemoths was the fight between Bill Ackerman and Carl Icahn over Herbalife Nutrition. Ackerman was the short and Icahn was running the

squeeze. Eventually Ackerman's loses got so high he had to throw in the tool and close out his position, losing millions in the process.

Yet, in the case of GameStop, it was not big boys of finance employing the squeeze but the little guy, the individual investor, basically Joe Q. Public. These were amateurs, indeed called "armchair traders", who have come into the market in a big way, driving up the price. There were a variety of reasons for this change in the squeezers. "Some smelled opportunity after stocks tumbled last spring, some were trying to scratch a gambling itch after sports leagues shut down, and for some it's just a game — trying to ring up dollars instead of points. All this has been made easier by the free trades available through platforms like Robinhood and E-Trade."

John Stark Reed said, "The Reddit story began to unfold when a group of energetic Reddit users decided to strike back against hedge funds by launching a buying spree of the stocks of GameStop and a few others, causing their prices to soar, and thrusting a "short squeeze" on the hedge funds holding those corresponding short positions." Enough of these traders but enough to drive the GameStop price up. Moreover, "If it goes high enough, the brokers who would be on the hook have to buy more shares, lest they get stuck having to buy a lot of expensive shares all at once. That increases demand, which increases the stock's price. Which means the brokers have to buy more shares," and the entire cycle starts again.

There were some big losers amongst the shorts, as a "A spokesman for Melvin Capital — which needed a $2.75 billion cash injection on Monday because of the squeeze — said the firm had closed out of its short position. Indeed, Melvin Capital lost 53% on its investments in January. Andrew Left of Citron Research, another short, said he had covered the majority of his short position "at a loss, 100 percent."

The other new wrinkle in this phenomenon was the social media angle. Donald Trump used social media effectively to cause his supporters to storm the US Capital. As Matt Kelly is want to say, social media does not create the message but amplifies it. But here these average Joe traders used social media to amplify their message through Reddit; trading tips and urging each other to "Buy High and Sell-Never".

While not new, some trading platforms have been aggressively pushing new traders. E*TRADE Financial Corporation has been around for 15 years or so but it charges $5.95 for a trade. Robinhood on the other hand lets traders transact at no charge. Interactive Brokers and others placed more restrictions on trading of GameStop and other stocks that have been caught up in the frenzy. Robinhood shut down trading on Thursday and then limited the ability of traders using its app to buy the call options, for example. How could they do so and, more importantly, why would they do so? Those are only some of the questions I will be exploring over the next few days.

If you are a CCO or compliance professional, you need to consider many questions brought up by the GameStop trading. How do the issues surrounding it impact compliance? What happens if the shorts target your company? How will new social media channels impact your organization?

Where do the regulators come in? Who are your stakeholders? These are but a few and there are many, many more. But just as Jed Gardner said, you now must prepare for the "unknown unknowns". How will you do so?

Finally, if you thought 2021 would be less of a wild ride than 2020, all I can say is to quote Bette Davis, "*Fasten your seat belts, it's going to be a bumpy night*".

II. The Shorts

Is your compliance program flexible enough to manage this change? Can it adapt to allegedly unforeseen crisis which will be with us going forward. The Department of Justice (DOJ) now mandates that a minimum best practice for any compliance program is both continuous monitoring leading to continuous improvement. This type of development is no longer a compliance program "nice-to-have" but a mandatory business practice. On to the shorts.

A. What is a Short Seller?

Short Sellers (shorts) have been around forever. In ancient Greece, where you could bet on just about anything, shorts bet against rival city-states, thereby driving value down. In more modern parlance, Mark Hulbert, writing in the New York Times (NYT) in 2010, explained that shorts "profit by finding stocks or other securities that will underperform the market". He went on to note, "Short-selling — borrowing shares and selling them, intending to buy them back later after the price declines — is a divisive issue. Traders who bet on the decline of a company, a currency or even an entire market aren't always popular. The billionaire investor George Soros was initially pilloried when he bet correctly in 1992 that the British pound would fall sharply."

Shorts became particularly controversial in the era of the bear market during and after the 2008 financial crisis. As reported by Michael Lewis in his book, *The Big Short*, many shorts turned a profit while almost all other investors were suffering. This powered many investors long-held beliefs that shorts were manipulating the market to induce the very price declines from which they profit. Moreover, where do shorts get their contrarian information?

Hulbert said, "the average short-seller has done well through astute research and analysis, not market manipulation." This was based on a study entitled "*How Are Shorts Informed? Short Sellers, News and Information Processing*." The authors, Joseph E. Engelberg and Adam V. Reed, both finance professors at the University of North Carolina at Chapel Hill, and Matthew C. Ringgenberg, a Ph.D. concluded, "in a vast majority of cases, short-sellers reacted to news articles when the rest of the market did. What, then, is the source of short-sellers' historical success? The researchers concluded that the most likely explanation was that short-sellers, compared with other kinds of traders, have a superior ability "to analyze publicly available information.""

B. Short and Distort

Why then do shorts have such a bad reputation? The answer is simple "short and distort". Jennifer Detrani, writing in Above the Law, said, "short and distort" is "a form of securities fraud wherein an investor takes a short position on a stock and then publicly berates the stock to influence it to drop." This is opposed to a "pump and dump" scheme which "involves overpromotion of speculative stocks before selling out at the top. Pumping and dumping works best in a bullish market and shorting and distorting works best in a bear market." Further, both schemes are potential securities law violations. The elements would include "(1) misrepresentation to the market through articles, blogs, and social media; (2) materiality, especially when false statements discuss a company's financial condition or viability; (3) an intent to deceive through market manipulation; and (4) connection to the purchase or sale of securities."

How does a short work? Typically, they take a short position and then announce it publicly. This publicity alone is usually enough to drive the stock down (if the short is big and/or well known enough). Some shorts pump this information out on social media channels explaining how or why they believe a stock is over-valued or over-priced. Do shorts distort the market? There are certainly are many that do so. Is it misrepresentation as noted above? Not if the shorts are wrong about the stock value. But what if the very act of announcing you are shorting a company drives a stock down, especially if your analysis is incorrect? Does this become a misrepresentation? Do you have to explain your reasoning, logic or is a 'just a hunch'? If a stock goes down after a short announces it is shorting the company, did the stock go down because it was over-valued or because someone cried wolf?

Do shorts aid in the market? Investopedia says, "Short selling strengthens the market by exposing which companies' stock prices are too high. In their search for overvalued firms, short sellers can discover accounting inconsistencies or other questionable practices before the market at large does." According to Hulbert, "James S. Chanos, a hedge fund manager, was a lone voice when he began betting against Enron in November 2000, long before the company collapsed". The same was true about Chanos when it came to the fraud which was WorldCom.

More recently we saw Bill Ackerman make a notoriously famous short selling bet against Herbalife Nutrition. He accused the company of being a pyramid scheme. Herbalife fought back ferociously saying it was a legal multi-level marketing company. Pyramid schemes are illegal, while legal multi-level marketing is, well, legal. Ackman also said that Herbalife was the most well-run pyramid scheme in the world, implying that the fraud they perpetrated was far-reaching and extremely deceptive. It turns out Ackerman was right that an illegal scheme was underlying Herbalife, but that illegal scheme was an entire business unit based on bribery and corruption in China. Was it Ackerman's short position which led to the Securities and Exchange Commission (SEC) looking into Herbalife as the company did not self-disclose that it was engaged in bribery and corruption? Whatever the reason, the company, according to a DOJ Press Release, "agreed to pay total penalties of more than $122 million to resolve the government's investigation into violations of the Foreign Corrupt Practices Act (FCPA)."

II. The Squeeze

I think the GameStop phenomenon portends a seismic shift in many areas. Matt Kelly often says that social media is not the message; it amplifies the message. Moreover, it connects literally armies of like-minded folks into a community where they can have real power. The Wall Street investment community found that out in a very powerful way over the past couple of weeks regarding GameStop. Wall Street had always perceived itself as immunity and protected from what they viewed as the whims of Joe Q. Public (or what Wall Street would derisively call 'the great unwashed'). The reason was not social but economic, Wall Street viewed the barrier to entry to achieve a position which could impact the stock market as too high. Obviously, these same people were not watching television on January 6, when the US Capitol was attacked.

What does this mean for the compliance professional? It means that literally anything come up and out of left field and end up as a high, hard one headed towards your corporate head. I know those are muddled baseball metaphor but a very muddled Spring Training will begin in two weeks so a tip of the baseball cap is in order. On to the Squeeze.

A. Roaring Kitty

How were so many main street traders able to impact the stock market in a way that may change it forever? Start at the beginning with the trader whose Reddit handle is Roaring Kitty. According to Nathan Popper Kellen Browning, writing in the New York Times (NTY), "In mid-2019, a Reddit user — known as "Roaring Kitty" on some social media accounts — posted a picture on an online forum depicting a single $53,000 investment in the video-game retailer GameStop. The post attracted little attention, except from a few people who mocked the bet on the struggling company...Over the next year, he began tweeting frequently about GameStop and making YouTube and TikTok videos about his investment. He also started livestreaming his financial ideas. Other Reddit users with monikers like Ackilles and Bowlerguy92 began following his every move and piling into GameStop."

B. Reddit

Reddit is an online platform which provides chat rooms for like-minded folks. In the instance of GameStop, it was WallStreetBets, which has more than 2 million followers. According to Allison Morrow, writing in CNNBusiness, the site is "littered with posts cheering the stock gains and no small amount of righteous indignation. The site not only provided information but in many ways egged investors on. One user said, "What I think is happening is that you guys are making such an impact that these fat cats are worried that they have to get up and put in work to earn a living," a moderator in the group posted this week." That fuzzy sensation you are feeling is called RESPECT and it is well earned. Wall Street no longer dismisses your presence anymore."

This approach is antithetical to the way Wall Street typically does business. Morrow quoted tech investor Chamath Palihapitiya for the following, "Instead of having 'idea dinners' or quiet whispered conversations amongst hedge funds in the Hamptons, these kids have the courage to

do it transparently in a forum," he said. "What it proves is this retail [investor] phenomenon is here to stay."

Matt Phillips, writing in the NYT said, "The traders' motivations vary widely. Some reason that GameStop's shares are a good value. Others are just riding the wave. And others want to squeeze Melvin Capital, a hedge fund that was shorting GameStop. They're the ones quoting Heath Ledger's Joker character from "The Dark Knight": "It's not about money; it's about sending a message."

C. The Squeeze

How did these main street investors, using such pedestrian tools as Robinhood and E*Trade potentially change the market forever? They did it through a maneuver called 'the squeeze'. Phillips wrote, "many are placing their own options bets, on the opposite side of the shorts. [See yesterday's blog on 'the shorts'] These bets involve contracts that give them the option to buy a stock at a certain price in the future. If the price rises, the trader can buy the stock at a bargain and sell it for a profit. The brokers who sell the options contracts have to provide the shares if the trader wants to exercise the option. To mitigate their risk, they buy some of the shares they'd need. Normally, this small amount of demand doesn't do much to the price. But if enough traders bet big, the demand can push the stock up. If it goes high enough, the brokers who would be on the hook have to buy more shares, lest they get stuck having to buy a lot of expensive shares all at once. That increases demand, which increases the stock's price. Which means the brokers have to buy more shares, which means … you get the idea."

Project Syndicate reported that "on January 27, investors that had taken short positions on GameStop lost $14.3 billion." Phillips reported that Melvin Capital, needed a $2.75 billion cash injection on January 25 because of the squeeze. Further, "the firm had closed out of its short position. Andrew Left of Citron Research, another short, said he had covered the majority of his short position "at a loss, 100 percent.""

Should the shorts have been ready for this? Isn't shorting a stock an inherently risky position to start with. Afterall, Bill Ackerman had to close out his short position against Herbalife eventually. Short seller legend Jim Chanos has been hurt by his short of Tesla. As late as December 2020, in a Barron's interview Chanos has cited corporate governance concerns, particularly when Tesla merged with a solar energy company controlled by Elon Musk. Chanos also has criticized Tesla for its reliance on sales of EV car tax credits for a huge amount of its revenue.

It is all about risk management, seeing around corners and as Jed Gardner reminds us "Business as Usual" in the 2020s.

III. The Regulatory Response

Next, I want to look at some possible regulatory responses and the one regulatory response which stopped the Robinhood trading platform for one day.

A. The DTCC

According to Investopedia, the "Depository Trust and Clearing Corporation (DTCC) is an American financial services company founded in 1999 that provides clearing and settlement services for the financial markets." Established in 1999, it combined the functions of the Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC), which is a subsidiary of the DTCC. The "DTCC settles transactions between buyers and sellers of securities and plays a critical role in automating, centralizing, standardizing, and streamlining the world's financial markets. When an investor places an order through their broker—and the trade is made between that broker and another broker or similar financial professional—information about that trade is sent to the NSCC (or an equivalent clearinghouse) for clearinghouse services."

Jeff John Roberts, writing in Fortune discussed this role, where the DTCC serves to centralize the settlement operations of all stocks and bonds, and is funded by banks and brokerages, including Robinhood. While the DTCC's activities are an integral element of financial markets, the process by which it assesses risk is not transparent. For instance, executives at Robinhood were greeted at 4 AM on January 28th with a demand for an additional $3 billion in capital based upon the trading volume.

The reason for the dramatic increase in collateral was the soaring price of GameStop "created fears the clearinghouse could be left in the lurch if prices suddenly cratered. Specifically, brokerages like Robinhood might not have the capital to cover a potential collapse in prices between when shares were purchased on Wednesday and when they cleared two days later. In the same way a brokerage can ask an individual investor to pony up more cash to cover a margin call, the NSCC wanted Robinhood to plunk down more money to avert risk."

B. The SEC

1. Robinhood

Many have been asking where the SEC has been in all of this. John Reed Stark, a former Chief of the Office of Internet Enforcement at the U.S. Securities and Exchange Commission (SEC),, writing in LinkedIn believes the SEC has been quite busy. He opined that the SEC may well have "initiated a dual track assault upon Robinhood: an investigation conducted by the SEC Enforcement Division and a "for cause" examination conducted by the SEC Examinations Division."

Further, Stark believes "the SEC has probably already dispatched an examination team to Robinhood" and has asked for or already "obtained a formal order of investigation, which activates certain added powers for SEC staff; Issued subpoenas for testimony, documents and other information requests to Robinhood; Begun coordinating efforts with the Financial Industry Regulatory Authority (FINRA) and other state and federal regulators and self-regulatory organizations, sharing intelligence, analysis and data; and Started reviewing the thousands of

complaints that are pouring to its online tip center, interviewing anyone who requires further inquiry and seeking documents from any tipsters as well.

He dryly concluded, "This is a hideous regulatory morass for Robinhood, which will incur tens of millions of dollars in legal fees merely to respond to SEC requests, let alone defend themselves later against any accusations of wrongdoing."

2. Reddit

What about the platform where all the touting of squeezing the shorts and highlighting the underappreciated value of GameStop occurred? The SEC said in a statement "[W]e will act to protect retail investors when the facts demonstrate abusive or manipulative trading activity that is prohibited by the federal securities laws. Market participants should be careful to avoid such activity."

Reed interpreted this statement to mean "SEC enforcement staff have begun gathering all of the Reddit and other relevant online posts, and dumping them all into an e-discovery database for searching, preserving, organizing, etc. The SEC staff are at this minute likely pouring over the data, searching for indications of wrongdoing, and seeking from Reddit any subscriber information maintained by Reddit that the SEC has the authority to request."

3. Reddit Users

What about the user of Reddit who touted the stock and created the herd mentality which drove the purchases of GameStop? Typically, if there is no deception, creating a herd to generate excitement about buy a stock and being transparent about your objectives, is not fraud in connection with the purchase or sale of a security and would not be investigated by the SEC. Yet as Stark noted, "The only possible exception being Reddit users who are also registered with the SEC as investment professionals or who run stock-picking newsletters. In such instances, those individuals, because of their special relationship with their customers and clients, arguably must meet a higher fiduciary standard."

Roaring Kitty is one of the most well-known Reddit users who touted all things GameStop. The New York Times reported that what was less well-known about his is that he is a registered securities broker. Further, until January 21, his day job was as a financial wellness education director at "MassMutual, officially known as Massachusetts Mutual Life Insurance Company, also informed regulators that Mr. Gill gave his notice on Jan. 21 but was technically still an employee of the firm and its securities and investment advisory arm, MML Investors Services, through Jan. 28 — the week when GameStop shares surged the most."

These are simply some of the regulatory responses which are or may not be in play. There are already some 30 shareholder actions filed against Robinhood. Who knows maybe the hedge funds which got caught in the squeeze may file suit against Roaring Kitty or others for their

intemperate attacks on their business model? Given the venom which came from the Hedge Funds who lost shorting GameStop, anything may be possible.

IV. Lessons Learned

Perhaps the first, most important and everlasting lesson of all time is that all market bubbles burst at some point. Throughout this series, I have been citing to Jed Gardner, Senior Vice President at Linedata Technology Services, who said about the Coronavirus health crisis and its impact on business, "we have moved from disaster recovery to business continuity to business as usual during the time of Coronavirus. He explained that "risk managers, compliance professionals and business executives now have to plan for the unknown unknowns in their business plans and risk management strategies." To conclude this series, I decided to ring up Jed in the UK and ask him about the entire GameStop matter and what it means for compliance professionals.

Gardner said that one of most important points was "can you move quickly enough to control events?" He began talking about GameStop, the company, Robinhood, the trading platform and the institutional investors, particularly the shorts, many of whom paid dearly for their short positions in GameStop. He said that Robinhood was clearly not ready for the type of transaction volume generated which led to a trading suspension on Thursday, January 28 because the DTCC demanded a cash infusion of $3 billion to clear Robinhood's trades. (This amount was later reduced to $1 billion.) This not only stopped the traders in their tracks but enraged many Robinhood customers who were blissfully unaware of the terms under which they traded on the platform.

While Robinhood may have had the legal right to suspend its users from trading in Robinhood, it was their ham-handed approach (with apologies to any hams out there). Mengqi Sun, writing in the Wall Street Journal, said, the company "is facing more than 30 civil lawsuits in relation to trading restrictions imposed by the online brokerage that temporarily limited purchases of certain securities last week". Many of these claims are based on state security laws which Robinhood may be woefully unaware of. In part of its disastrous response, Robinhood "said the restrictions stemmed from regulatory requirements and risk management considerations as a brokerage firm. That includes net capital obligations required by the Securities and Exchange Commission and deposits requirements from its clearinghouses, which process the securities on the back end after a user executes a trade with their brokerage." Of course, this statement only came after it suspended trading on the 28th, when "the amount required by clearinghouses to cover the settlement period of some securities rose tremendously".

But Gardner said it is more than trading companies, financial institutions, hedge funds and social media platforms who need to study the past few weeks for lessons. It is literally every industry which needs to be aware of this matter. You need to understand what is being said about you, your industry, where and how you do business so you can be prepared if it all blows up. The GameStop phenomenon did not appear overnight. It had been building for months. In the Reddit chatroom at the center of the trader's world, r/WallStreetBets, traders like Roaring Kitty had

been touting GameStop stock since at least September 2020. Many had done this based upon market research and positions taken by the Shorts. But the more interesting part was that later traders made their decisions to purchase GameStop solely based on the moves of people like Roaring Kitty. Robinhood apparently allows you to follow your favorite traders and many purchasers of GameStop did so and bought simply because he did.

In other words, follow a key player, do what they do and you will be rewarded like they are. That is about as close to location, location, location as you can get in the trading world. This is not entirely new as some investors purchase stock after people like Warren Buffet does but Robinhood seems to drive this sort of herd behavior in a way not previously seen.

Now take that same herd mentality and apply it to a social media cause such as modern slavery or responsible sourcing. What if there is a significant discussion going on in any Reddit chat room so dedicated to that topic? It could go on for months and then some spark could ignite it for all the world to see. What if your company was named? What if a key supplier was named? Would you be ready to respond? Would your compliance program be ready to respond in a documented manner which could refute any such allegations?

What about your own employees? What if they are a part of those discussions? Is that activity protected under the National Labor Relations Act? Is it free speech? What about Mass Mutual and its former employee, Roaring Kitty? The New York Times (NYT) reported that he is a registered securities broker. Further, until January 21, his day job was as a financial wellness education director at "MassMutual, officially known as Massachusetts Mutual Life Insurance Company, also informed regulators that Mr. Gill gave his notice on Jan. 21 but was technically still an employee of the firm and its securities and investment advisory arm, MML Investors Services, through Jan. 28 — the week when GameStop shares surged the most."

Do you think there was any conflict-of-interest present? What if Mass Mutual invested in GameStop? Apparently, "MassMutual, has told securities regulators in Massachusetts that it was unaware that Mr. Gill had spent more than a year posting about GameStop. The insurer also told regulators that had it known about Mr. Gill's outside activities, it would have asked him to stop or possibly fired him." But it is not as if Roaring Kitty was hiding in the shadows or even hiding in plain sight, as he was (and still is) on social media, online message boards and YouTube.

Finally, what does all this mean for zeitgeist? Gregg Greenberg, General Manager & Host, C-Suite TV, observed the following, "The battle over GameStop has very little, if anything, to do with GameStop. It has to do with supply, demand and a bunch of hedge funds that were far too confident in their thinking. It was nice to see so-called Main Street Investors rise up and stick it to the so-called Masters of the Universe. The result will be a far more efficient market and the prevention of collapses like we saw during the mortgage and Long Term Capital crises where Uncle Sam bailed out the financial elites. Hats off to all those folks in their parents' basements sticking it to all those folks in their Greenwich and Hamptons mansions."

This is a sentiment that was expressed by both Occupy Wall Street and some Tea Party members after the 2008 financial crisis, where Wall Street was bailed out with no legal consequences for tanking the economy. Joan Donovan, writing in Politico, found those "folks in their parents' basements" as direct descendants of the Occupy movement. She wrote about protestors in Zuccotti Park in Manhattan's financial district, "there to protest limits imposed on "the little guy"." She drew a direct line from the Occupy protesters whose home base was that same Zuccotti Park to those of today, the "retail stock traders who had found a way to make money by banding together on the Robinhood trading app to move the markets."

But if you go back to the original Tea Party (before the GOP Co-opted it into a racist throng); there was a small group focused on the economic inequality emanating from the Wall Street elite. The point of both is that there is a large group of folks who are ready, willing and now able to stick it to the man. If they focus their collective ire on your organization, will you be ready?