UNIVERSITY OF TORONTO
FACULTY OF LAW

Investor Protection Clinic

INVESTOR PROTECTION CLINIC
UNIVERSITY OF TORONTO
78 QUEEN'S PARK
TORONTO, ONTARIO
IPC.LAW@UTORONTO.CA
WWW.IPC.LAW.UTORONTO.CA

An IPC Brief - Spring 2021

WHAT HAPPENED WITH GAME STOP?

A Summary of Events (so far)

On January 13, 2021 financial markets were shocked when the stock of GameStop, a company that had posted significant losses in the past two years, abruptly rose nearly 60% in one day. Over the next few days, the price of GameStop's stock continued to skyrocket—it peaked at $347.51 on January 27. GameStop's stock price had gone up over 1600% in just two weeks. The price subsequently fell to less than $50 by February 16. This massive spike in GameStop's stock price, followed by its rapid decline, has led to much confusion as to what exactly happened.

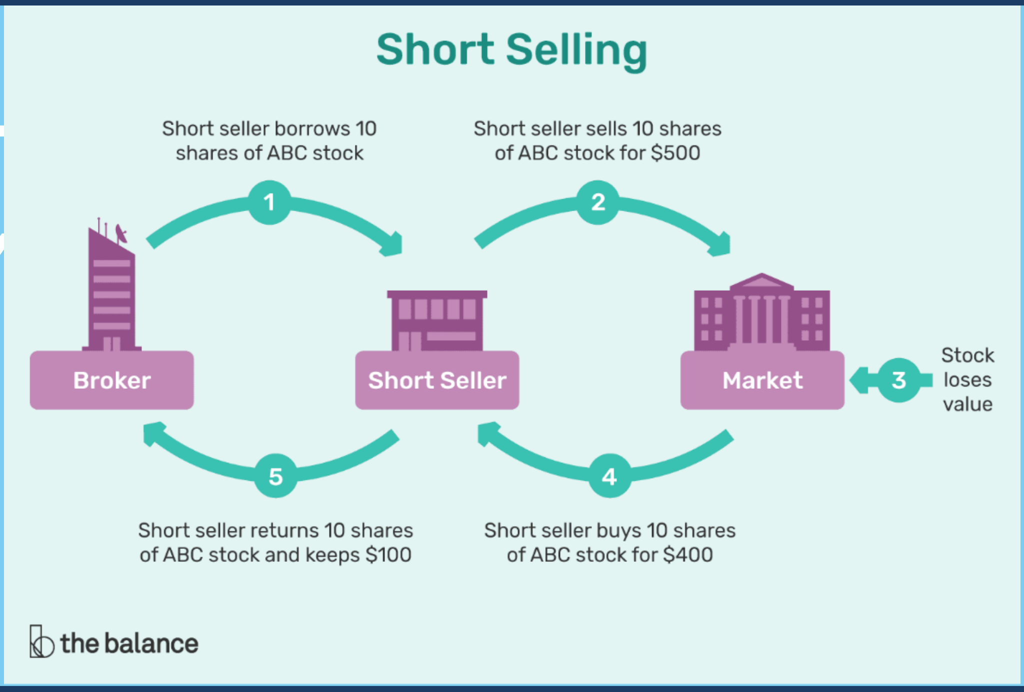
In a nutshell, a group of users of the social media platform, Reddit, noticed that more than 100% of the outstanding shares of GameStop had been sold "short." Many users of the Sub Reddit r/WallStreetBets discussed taking "long" positions to capitalize on the considerable short interest in the market, which ultimately drove up the price of the stock at the expense of traders who had sold GameStop stock short. The massive rise in the price of GameStop's stock resulted in some brokerage platforms temporarily restricting trading of GameStop. The actions of the brokerage platforms have drawn much scrutiny from their clients and from lawmakers. Although it is still unclear what the fallout from the spike in GameStop's stock price will be, there are some important lessons that can be discerned from the GameStop Saga, from an investor protection perspective.

WHAT IS SHORT SELLING?

Short selling is an investment or trading strategy that speculates on the decline in a stock or other security's price. It is a complicated and risky strategy that ought to only be undertaken by experienced traders and investors.

Traders may use short selling as speculation, and investors or portfolio managers may use it as a hedge against the downside risk of a long position in the same security or a related one. Speculation carries the possibility of substantial risk and is an advanced trading method. Hedging is a more common transaction involving placing an offsetting position to reduce risk exposure.

In short selling, a position is opened by borrowing shares of a stock or other asset that the investor believes will decrease in value by a set future date—the expiration date. The investor then sells these borrowed shares to buyers willing to pay the market price. Before the borrowed shares must be returned, the trader is betting that the price will continue to decline, and that they can buy them at a lower cost. The risk of loss on a short sale is theoretically unlimited since the price of any asset can climb to infinity.



ONLINE COMMISSION-FREE TRADING PLATFORMS

Online commission-free trading platforms were used by the individuals who purchased GameStop's stock to drive up the price. One very widely used by the individuals from r/WallStreetBets was Robinhood. However, in a controversial move, Robinhood temporarily suspended trading of GameStop (among a handful of other highly volatile stocks) on its platform. Unsurprisingly, this move sparked outrage among users of the platform, and has led to class-action lawsuits being filed against Robinhood. In a recent hearing before the House Committee on Financial Services, the CEO of Robinhood defended the company's decision to suspend trading of GameStop saying that Robinhood (and other brokers) had no choice but to suspend trading.(2)

In 2013, Robinhood announced its intention to make zero-commission trading the centerpiece of its business offering.3 By October 2019, much of the brokerage industry had followed suit in offering zero-commission fee structures, as Charles Schwab Corp. and Interactive Brokers announced they were eliminating online trading commissions for stocks and ETFs listed on U.S. or Canadian exchanges, while TD Ameritrade Holding Corp. took a similar step that same month. (4)

In the United States, the big names with free trading options as of the start of 2021 include Merrill Edge, ETRADE, TD Ameritrade, Robinhood, and SoFi. Vanguard, Fidelity, and Charles Schwab all have their own platforms as well. Interactive Brokers offers no-free trading in U.S. stocks, although its marketing focus is on global markets. (5)

WealthSimple launched its "WealthSimple Trade" service in March 2019, becoming the first (and only as of March 18, 2021) zero-commission trading platform in Canada.(6)

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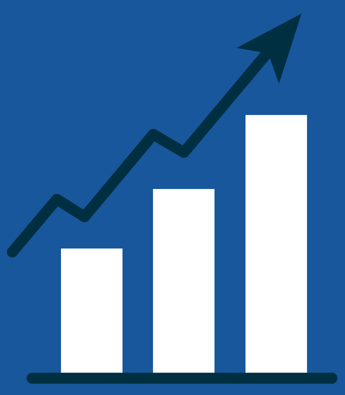
THE BUBBLE - PART 1

Short selling is a tool that can help improve market efficiency by lowering the valuations of weak companies, but like most market mechanisms, at the extremes things get more complicated. Short sellers, having borrowed shares, are then obligated to be future buyers of the stock. They put themselves in that position as they expect the stock price to go down, such that when they buy the shares back, they can return what they borrowed at a lower price and pocket the difference.

As such, as short interest grows, there is a short-term downward push on the price (the initial sale of the borrowed shares), but also future upside pull on the stock price as a natural result. Normally this pressure is subtle enough that the stock price will not significantly move. However, when large-scale institutional investors started taking large short positions in GameStop (GME), the short interest was more than 140% of the float. Consequently, there was a critical mass of short interest hanging over GME's price.

Why would the hedge funds short more shares than were out on the market? Because they expected GME to declare bankruptcy in the very near term so that returning borrowed shares cost $0, as the shares are worthless at that point. A side-effect of this considerable sell-side pressure on the stock is that it becomes more difficult for GME to obtain any kind of financing to avoid bankruptcy, making it, in theory, a self-fulfilling prophecy. This of course, is not how it played out...

THE BUBBLE - PART 2



Concurrent to the hedge funds' short interest, spurred on by the chat on Reddit, a large numbers of retail investors began taking long positions (i.e. the opposite side of the bet) through a combination of buying the GME stock, and, more crucially, buying call options—which give the holder a right to buy a stock at a certain price, and function much like a leveraged bet—on GME. Many of these retail investors were discussing—and to an extent, coordinating—these long positions through forums on r/WallStreetBets, a community on the social news aggregation website Reddit.

Options are particularly powerful trading tools. They can be used to bet on financial securities in a way that can magnify returns (and losses), which has made them very popular with younger retail traders. Specifically, call options have proven to be a revelation on r/WallstreetBets: these options give holders a right to buy a stock at an agreed "strike" price within a certain date.

The more sophisticated traders on these internet forums also appears to be taking advantage of some of the unique characteristics of options, often denoted with Greek letters such as "delta" and "gamma", to drive prices higher.

The reason why options can have an outsized impact on the underlying stock is because of their unique dynamics. The seller of an option, typically a bank or another big financial institution, is obliged to deliver the promised shares if call strike prices are triggered, or to buy the shares in the case of put options. Dealers will therefore hedge themselves by buying/selling the underlying security. This can trigger feedback loops, especially when stocks start moving towards the strike price and banks are forced to hedge their exposure.

Some analysts say many retail investors have learnt that by banding together to blitz-purchase calls, they can help drive the price of the underlying stock up to the strike prices by compelling dealers to hedge their own exposure. "Weaponized gamma is a perfectly reasonable way of describing it," said Benn Eifert chief investment officer of QVR Advisors, a hedge fund. "You see a lot of snide comments that these are just dumb people. But there are clearly sophisticated, clever, thoughtful people doing this as well." Steve Sosnick, chief broker at Interactive Brokers, agreed and said the feedback loops could become particularly powerful when the gamma hedging of dealers was combined with small stocks that had a limited proportion of freely tradable shares and were subject to big short positions — such as GameStop. One prominent WSB user posted screenshots showing how he had turned about $50,000 worth of GameStop call options into nearly $23m this year.

THE BUBBLE - PART 3

On January 28, Robinhood, a popular online trading app, halted purchases of GameStop (along with other volatile stocks such as AMC Theaters and Blackberry Limited) from trading on its platform. While Robinhood customers were unable to purchase any GameStop shares, they were still able to sell the shares they already owned. Robinhood stated that the restrictions were the result of clearing houses (i.e., the middlemen in a trade) raising the required collateral (i.e. cash) for executing trades due to the high market risk from GameStop.

Robinhood's trading restrictions continued into the beginning of February, and GameStop's stock price began to fall drastically from February 1st to February 2nd, losing more than 80 percent of its value from its peak price. CNN reported that the drop was partly due to restrictions imposed by Robinhood (and other brokers).8 GameStop's stock price continued to decline during the week.

Despite the decline, some r/wallstreetbets users rallied to convince other users to hold on to the shares, arguing either that they would increase in value or that such an action would send a political message. As the stock prices continued to decline, some of the recent investors held on to their shares and suffered significant losses.

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LEGAL ACTION

A Massachusetts-based man named Brendon Nelson was the first to file a class-action lawsuit against Robinhood, demanding it pay up in damages for depriving users of the chance to buy GameStop stock. Since then, users across the US have filed similar complaints, and over 30 class-action lawsuits have been filed against Robinhood for restricting stock buys on the app.

On January 28, a class-action lawsuit against Robinhood for alleged market manipulation was filed in the Southern District of New York. The lawsuit alleges that the app "purposefully, willfully, and knowingly removing the stock 'GME' from its trading platform in the midst of an unprecedented stock rise [...] deprived retail investors of the ability to invest in the open-market and manipulating the open-market."

However, the lawsuits may not have much of a chance in court. Robinhood's customer agreement notes it has the power to stop stock buys, without any prior notice. The company also claims it had no choice but to restrict the stock buys due to it running out of cash to cover the transactions. "The amount required by clearinghouses to cover the settlement period of some securities rose tremendously this week. How much? To put it in perspective, this week alone, our clearinghouse-mandated deposit requirements related to equities increased ten-fold," the company wrote in a blog post.

GOVERNMENT ACTION

In addition to the lawsuits mentioned above, the United States Government is looking into what exactly happened with GameStop. Robinhood executives, Redditt executives, hedge fund managers and people like Keith Gill (one of the traders from r/WallStreetBets) appeared in front of the House Committee on Financial Services on February 18, 2021. The committee touched on everything from Robinhood halting trades of GameStop stock to whether short selling should face greater regulation. It is apparent that the events that transpired with GameStop's stock has gained the attention of numerous lawmakers; however, it is yet to be seen whether it will result in widespread changes to market regulation.

The Securities Exchange Commission (SEC), the financial market regulator in the United States, is investigating social media posts (including those on r/WallStreetBets) to see if there was any fraud. SEC Investigators are reviewing social media posts, together with trading data, to uncover whether the posts were part of a manipulative effort to drive up the price of GME. The SEC is looking, in particular, for misinformation meant to improperly sway the market. Although it is unclear whether the investigation will lead to fines, or other disciplinary action, in the past the SEC has fined individuals who have made false, misleading statements about stocks online.

LESSON LEARNED? TAKEAWAYS FOR RETAIL INVESTORS

Be wary of social media hype. Social media is reactionary by nature: try to avoid the initial frenzy and analyze news with a critical eye. Social media can also cause echo-chambers of opinion where you aren't getting all sides of the story. Social media tends to only show the positive side: people are much more likely to share and upvote posts about the money users have made than posts about users losing money.

Do your own research. Don't invest in companies you don't understand. Be aware of ALL of the risks when you invest in a stock.

Joining a viral trend does not limit your personal risk. When taking action in concert with other market participants, understand exactly what it is you are doing to avoid potential liability.

Don't feel obligated to invest alone. While online brokerages are convenient for people who want to buy stocks on their own, they aren't for everyone. Other options include robo-advisors or using an investment advisor who can either make recommendations or manage your investments based on your circumstances and goals.

Investing is not a morality tale. Many Robinhood users bought GameStop to make a political statement on behalf of ordinary individuals against the large hedge funds of Wall Street. Ultimately, many of these individuals ended up losing most of their investments. While it's okay to invest in companies supporting causes you believe in or companies you agree with ethically*, this should not necessarily be the primary consideration when choosing which stocks to buy.

Investing is not a game. Forums like r/wallstreetbets treat the stock market like a casino and accordingly place very risky bets. Don't use the stock market to gamble; use it to park your savings in investments that will grow steadily over time.

Don't try to time the market. While it may be tempting to try and buy stocks for the short-term and sell them while they are at their highest price, this is largely a guessing game and can lead you to suffer serious losses. Try to focus on investments that you would be happy with holding over a longer timer horizon (at least a few years, but ideally much longer).

Diversify. Don't put all of your eggs into one basket. Spread your money across a number of companies in different regions and industries to limit risk through diversification. Buying ETFs that track a broad index (like the S&P 500) are a great way to easily diversify your savings.

***Note:** the political goals of r/WallStreetBets users were completely separate from GameStop's corporate policies.

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