215 Pennsylvania Avenue, SE • Washington, D.C. 20003 • 202/546-4996 • www.citizen.org

Testimony of

Bartlett Naylor, Susan Harley, Remington Gregg[1]

Congress Watch, a division of Public Citizen

Virtual Hearing: "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide?"

U.S. House of Representatives

Financial Services Committee

February 18, 2021

On behalf of Public Citizen's more than 500,000 members and supporters across the country, we provide the following testimony for the virtual hearing entitled: "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide?"

In theory, the stock market serves as an intermediary between savers and users of capital. Companies can raise money from savers in the public stock market to expand their operations and employ a greater number of workers. Following an initial public offering, the ownership of a corporation changes hands through stock sales. Financial theory says the value of those shares should be the present value of future earnings. Future earnings, naturally, involves judgment, so there can always be an understandable variation in stock prices for a publicly traded company. Routine and special disclosures constantly update these judgments as well, and firms exceed or disappoint expectations. Patient investors often ride through the swings in stock prices if they remain confident in the long-term prospects of a firm. Traders and speculators who hold for short periods provide important price discovery, just as recent home sales in yields insight on the value of the unsold homes in a neighborhood.

[1] Naylor is financial policy advocate, Harley is managing director, and Gregg is counsel for civil justice and consumer rights with Public Citizen's Congress Watch division.

The GameStop mania is but one example that finance theory doesn't always determine market prices and that trading practices can distort capital markets.

The January trading frenzy surrounding the publicly traded company GameStop[2] has exposed a number of fundamental problems with our capital markets including its intersection with social media. Some of these problems can be addressed with better enforcement of existing laws and rules, while others invite additional rules and new legislation.

GameStop is a bricks-and-mortar retailer of electronic games. Because internet retail threatens the viability of traditional storefront business, a number of sophisticated investors believed that the firm's prospects were negative and took so-called short positions.[3] A "short" is where the trader borrows stock, sells it, then, if the stock does declines, purchases that amount elsewhere and returns it to the lender. The short trader profits when the subsequent purchase price is lower than the sale price. But if the price goes up, the short trader must still purchase the stock, and will suffer a loss. The decision when to cover the short (buy the stock or post money) can be forced if the price rises dramatically.

In the case of GameStop, retail investors apparently noted that the amount of stock subject to this short ("short interest") was extraordinary. They rallied to purchase GameStop, driving up the price. Excitement for this rally played out on a social media platform called Reddit. Some traders encouraged each other on Reddit to hold firm and not sell.

In fact, the price rose dramatically. Overpaying for any stock is risky, as the only way to profit is to find a buyer willing to pay an even higher price. In the case of a firm with a sizeable short interest, those buyers could be short traders required to cover their positions. This is known as a "short squeeze."

Many of these retail investors traded stock through Robinhood Markets, Inc., a five-year old California brokerage firm founded by veterans of high frequency computerized trading. On the surface, Robinhood offers trading free of commissions. Instead, Robinhood derives a sizeable portion of its revenue by selling its customer orders to another firm, a process called "payment for order flow." There, these orders become part of a high-speed trading machinery where algorithmic computers make lightning-fast trades.

Much of this narrative is incomplete and awaits a thorough audit. Was this truly a case of small traders bringing down sophisticated market players? Did the retail investors knowingly engage in a short squeeze? And does this constitute unlawful market manipulation? How does the firm that pays for order flow profit? Do high speed traders' profits come from retail investors? During the trading frenzy, Robinhood temporarily suspended trading in GameStop. Why, and who benefited?

Payment for Order Flow

Broker-dealers such as Robinhood may receive a rebate for routing orders to certain trading venues. This raises a red flag because it calls into question whether the broker meets its obligation for best execution, namely, securing the highest price offered for a sale, or the lowest for a purchase. There may

---

[2] Emily Stewart, *The GameStop Stock Frenzy, Explained*, VOX (Jan. 29, 2021) / https://bit.ly/37nJao9.
[3] Michael de la Merced, *Gamestop's Stock Continues To Soar, As Small Traders Team Up Against Big Institutions*, NEW YORK TIMES, (January 27, 2021), https://nyti.ms/2NDBBCJ.

be a hidden fee that is difficult for regulators to detect, especially given the enormous volume of trading. It is inconceivable that the venue offering the rebate does so for charitable reasons. Arguably, the payments for order flow are hidden costs to the investor or should go to the investor.

Originally, Robinhood did not disclose to investors that it derived revenue from selling the right to its trades. On its website under the title "How We Make Money," it listed two sources, namely, fees for trading with loans from Robinhood, known as margin trading, and interest from customer deposits. However, it did disclose to the Securities and Exchange Commission (SEC) that that it engaged in payment for order flow.[4] It is not clear why Robinhood considered that unimportant for its customers. But the practice can involve a conflict to its obligation to find the best buy and sale prices for its customers. It is no surprise, then, that the SEC fined Robinhood $65 million in December 2020 for failing to inform clients that it sold their orders. [5]

Given that the conflict of interests between the customer and the brokers, the practice of payment for order flow should be banned.

Financial Transaction Tax

Given that at least some of the revenue that makes free commissions possible comes from high frequency trading firms' payment for order flow and it has been alleged that the high-frequency trading firm Citadel is allegedly "front running" the trades that it receives via Robinhood,[6] this trading practice must also be examined.

Most trading today is executed not by individuals making deliberate decisions about the value of a stock based on fundamental analysis of a firm's prospects, but by computers programed with algorithms that detect patterns. One of the key sources of information for these computers are those trades made by real people, such as retail trades routed to these firms.

Documented in Michael Lewis' book, Flash Boys, high-frequency traders make their profits by being able detect and trade faster than large investors – also called "whales"—like retirement and pension funds.[7] A study by the chief economist of the Commodity Futures Trading Commission (CFTC) found that high-frequency traders make an average profit of more than $5 when they "...go up against small traders buying and selling one of the most widely used financial contracts."[8] Globally, high-frequency trading has been shown to increase costs for investors by $5 billion annually.[9]

---

[4] Dave Michaels, *Robinhood Faces SEC Probe for Not Disclosing Deals With High-Speed Traders,* WALL STREET JOURNAL, (Sept. 2, 2020) https://on.wsj.com/3dmvVYX.

[5] Hannah Denham, *Robinhood Agrees to $65 Million Civil Penalty to Resolve SEC Charges*, WASHINGTON POST, (Dec. 17, 2020) https://wapo.st/3jVKeoy.

[6] Alexis Goldstein, *What Happened With GameStop?*, MARKETSWEEKLY (Jan. 28, 2021) https://bit.ly/3s3Jsse.

[7] Michael Lewis, *Michael Lewis Reflects on His Book* Flash Boys*, A Year After It Shook Wall Street to Its Core*, VANITY FAIR (March 12, 2015) https://bit.ly/2M3YWxg.

[8] Nathaniel Popper, *High-Speed Traders Profit at Expense of Ordinary Investors,* NEW YORK TIMES (Dec. 3, 2012) https://nyti.ms/3dr4f51.

[9] MATTEO AQUILINA, ERIC BUDISH AND PETER O'NEILL, FINANCIAL CONDUCT AUTHORITY, QUANTIFYING THE HIGH-FREQUENCY TRADING "ARMS RACE": A SIMPLE NEW METHODOLOGY AND ESTIMATES (Jan. 2020) https://bit.ly/3bXO7Y9.

High-frequency trading also has been shown to exacerbate volatility. The Flash Crash of May 2010 shows how quickly markets can fluctuate, when high-frequency trading was blamed for worsening a trillion-dollar crash that happened in a matter of minutes.[10] There is ample evidence that more recent market upheavals have been worsened by high-speed computer trading as well.[11]

Public Citizen has long called for a financial transaction tax that would bridle high frequency trading that otherwise acts as a tax on average investors without providing any of the societal benefits that would come from the government taxing trades. A financial transaction tax of just 0.1% (10 cents per $100 traded) would raise nearly $777 billion over 10 years[12] that could be reinvested in American communities through increased funding for health care, education, infrastructure or other priorities.

Gamification

If retail investors are unwitting victims of hidden fees and high frequency traders, how are they enticed into this market? While capital markets should be venues for clearheaded investors, some brokers seem to have engaged in gamification.[13] In December 2020, the Massachusetts Securities Division charged Robinhood with "aggressively marketing itself" to investors "without regard for the best interests" of their customers.[14] A key tool, the state agency alleged, was "gamification."[15] During a period of "exponential" growth, Robinhood used "advertising and marketing techniques that targeted younger individuals … with little, if any, investment experience."[16] The Massachusetts agency alleged that this gamification failed to oblige state law that requires a firm to act in the best interest of customers. We believe the SEC should also inspect whether this gamification violates any broker duties to clients, including a duty to disclose the risks of investing commensurate with the advertisement of any benefits. Legislation may be required to strengthen the ability of the SEC to police gamification. One 20-year-old Robinhood investor took his own life when he saw a $730,000 negative balance on his account, which he erroneously believed he owed. [17]

This gamification requires careful attention because in addition to Robinhood, more established brokers such as Schwab, Fidelity and TD Ameritrade have moved to zero cost trading. This can include trades for

---

[10] ANDREI A. KIRILENKO, ET. AL., THE FLASH CRASH: THE IMPACT OF HIGH FREQUENCY TRADING ON AN ELECTRONIC MARKET, JOURNAL OF FINANCE (Jan. 6, 2017) https://bit.ly/2XZAxLE.
[11] Robin Wigglesworth, Volatility: How "Algos" Changed the Rhythm of the Market, Financial Times (Jan. 9, 2019) https://on.ft.com/3aubPdp.
[12] CONGRESSIONAL BUDGET OFFICE, OPTIONS FOR REDUCING THE DEFICIT: 2019 TO 2028, at 298 (Dec. 2018), https://bit.ly/2SNA0b1.
[13] Annie Massa and Edward Robinson, *Robinhood's Role in the 'Gamification' of Investing,* WASHINGTON POST (December 21, 2020), https://wapo.st/37nL48w.
[14] COMMONWEALTH OF MASSACHUSETTS SECURITIES DIVISION, *In the Matter of Robinhood Financial,* (Dec. 16, 2020) https://bit.ly/2LYXjRk.
[15] Annie Massa, Michael McDonald, and Sophie Alexander, *Robinhood Is Accused of "Gamification" by Massachusetts*, BLOOMBERG WEALTH (Dec. 16, 2020) https://bloom.bg/2Zr6Svk.
[16] COMMONWEALTH OF MASSACHUSETTS SECURITIES DIVISION, *In the Matter of Robinhood Financial,* (Dec. 16, 2020) https://bit.ly/2LYXjRk.
[17] Matt Egan, *He Died By Suicide Thinking He Owed $730,000. Now His Family Is Suing Robinhood, CNN (Feb . 9, 2021) https://cnn.it/3arI0tJ.*

as little as $1. At such a small level, this might encourage more frequent transactions that are more akin to caprice than sound investment but can have tragic consequences.

Manipulation

While identifying what the "real" price of any firm is subject to the daily assessment of investors, there can be little argument that the wide swing in the price of GameStop evinces a departure from what should be a rational valuation of the company. The company began the year trading at less than $16 per share, then rose to more than $300, then abruptly fell below $50. GameStop reported no significant material change to its business prospects; instead, the price changed due to trading dynamics. Federal law such as Section 9 of the Securities and Exchange Act prohibits manipulation[18] and the SEC has brought cases for short squeezes under its anti-manipulation statutes.[19]

If the GameStop trading frenzy constituted a short squeeze, it is difficult to identify those who may have engaged in manipulation because they may have been legion. While some narratives point to small investors taking on sophisticated institutions, others point to large traders joining in the squeeze. In a statement during the GameStop trading frenzy, the full SEC commission declared, "We will act to protect retail investors when the facts demonstrate abusive or manipulative trading activity that is prohibited by the federal securities laws."[20] We encourage the SEC to examine evidence of an intentional short squeeze, including related statements made on social media platforms. The SEC through its Office of Internet Enforcement brought numerous cases of stock promotion schemes orchestrated through online message boards. [21]

The SEC should also stand up the long delayed Consolidated Audit Trail (CAT). The SEC and CFTC should be able to access in real time information on trading activities. Proposed in the aftermath of the Flash Crash of 2010, when the market swings defied immediate explanation, the CAT promises to examine market disruptions immediately and identify any misconduct. It is revealing that certain industry participants have resisted the CAT, arguing that what remains in the shadows may benefit Wall Street to the disadvantage of investors.

On the other hand, we do not believe that short selling falls in the same category as market manipulation. Shorting stock has long drawn criticism from corporate executives whose firms are subject to this pressure. But corporations employ investor relations departments to extol the virtues of companies that can border on puffery. Short sellers can balance this. Indeed, short sellers helped to unmask many frauds, including Enron. Better transparency for short selling is welcome, but Public Citizen opposes efforts to bridle this important safeguard.

---

[18] 15 USC 78(i).

[19] *Philip A. Falcone and Harbinger Charged with Securities Fraud,* SECURITIES AND EXCHANGE COMMISSION (June 27, 2012) https://bit.ly/3ka7jnH.

[20] *Statement of Acting Chair Lee and Commissioners Peirce, Roisman, and Crenshaw Regarding Recent Market Volatility,* SECURITIES AND EXCHANGE COMMISSION (Jan. 19, 2021) https://bit.ly/3s3EwUe.

[21] Bruce Brumberg, *Reddit And GameStop Lessons: Former SEC Enforcement Chief Explains Stock Manipulation And How To Avoid Trouble*, FORBES (Feb. 4, 2021) https://bit.ly/3u4ETjk.

Arbitration

Robinhood includes a forced arbitration clause in its customer agreement[22] which seeks to bar aggrieved customers from accessing the courts when harmed. Robinhood restricted trading during certain periods of the GameStop frenzy. According to one complaint, "Robinhood knew its actions would result in the restricted stock prices to plummet. By doing so, they were looking out for Wall Street hedge funds at the expense of the individuals who were customers of Robinhood."[23] Whether the traders will be able to proceed with their claims in a timely manner depends on whether they will be able to proceed to court, or be required instead to arbitrate through the FINRA arbitration system.

Public Citizen supports legislation that would prohibit companies from forcing individuals into predispute, binding arbitration and instead give every person the ability to decide the best venue for them to adjudicate claims.

CEO Pay

On paper, the CEO of GameStop sat on enormous gain from the frenzy. Since the end of 2020, the value of his stock-based compensation soared from $44 million to nearly $1 billion.[24] Now that the stock has declined from its peak, his holdings are worth far less. Executives are forbidden from selling stock outside of a plan and it is likely that the CEO did not cash in on this frenzy. But the episode illustrates that CEO compensation by way of stock options does not necessarily reflect business success but can stem from imperfections in markets.

Conclusion

The GameStop trading frenzy exposed much that has gone awry with our capital markets, from gamification, to hidden trading costs, manipulation, and the lack of opportunity for legal redress. The GameStop episode will not be isolated. Already, frenzies have overtaken trading in other companies.[25] Much must be done to ensure the integrity of our capital markets to ensure they serve investors and the economy fairly and efficiently and we laud the committee for its investigation into this episode.

---

[22] *Robinhood Financial LLC & Robinhood Securities, LLC Customer Agreement*, ROBINHOOD (June 2020), https://bit.ly/37mPGf9.

[23] Roman Chierello, *Robinhood Faces Class-Action Lawsuit Over Trading Platform That's "Designed To Go Down"'* FOXBUSINESS (Feb. 9, 2021) https://fxn.ws/37nLDiA.

[24] Lance Lambert, *GameStop CEO's Shares Are Worth Nearly $1 Billion—And, Boy, Does He Probably Want To Sell*, FORTUNE, (Jan. 29, 2021) https://bit.ly/2Nig6rx.

[25] Sebastian Pellejero, *BlackBerry, AMC and Other Reddit YOLO Favorites That Aren't GameStop*, WALL STREET JOURNAL, (January 26, 2021), https://on.wsj.com/3beqdpg.