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TESTIMONY

WHO WINS ON WALL STREET? GAMESTOP, ROBINHOOD, AND THE STATE OF RETAIL INVESTING

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Who Wins on Wall Street? GameStop, Robinhood, and the State of Retail Investing

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Chairman Brown, Ranking Member Toomey, and Members of the Committee:

I am pleased to have an opportunity to comment on several timely and important issues related to the federal securities laws. I have extensive experience with those laws. I was Deputy General Counsel of the Securities and Exchange Commission from mid-2006 to March 2009 and taught courses on securities regulation at the University of Virginia School of Law from 2014 to 2019. For many years, I was a partner in the securities enforcement practice of Wilmer Cutler Pickering Hale and Dorr LLP and am currently a senior affiliated scholar with the Mercatus Center at George Mason University.

My testimony will address (1) the recent trading activity in the common stock of GameStop Corp. and a few other companies, (2) securities trading platforms such as Robinhood Financial, and (3) considerations for further action. My conclusion is that the information currently available has not revealed a problem of sufficient severity to justify Congress imposing new regulations in these areas. New information could change that, but, in any deliberations about possible additional legal restrictions, Congress should give weight to and respect the personal liberty interests involved.

GAMESTOP

The rapid increase and decrease in the price of the common stock of GameStop and a few other companies has received a great deal of attention. My information about the events during the past several weeks is from publicly available sources, and my understanding is that various investigations into the details are being conducted. My views are based on the public information, but new information and details from the investigations could affect my opinions. I am open to persuasion from new facts.

Based on the information I have seen, misconduct probably did not occur in the recent trading of GameStop. Some concerns about a pump-and-dump scheme or a manipulation have been raised, but the public information does not bear those fears out. In the standard type of pump-and-dump scheme, one or more persons make material false or misleading statements to the market to drive a stock price up or down. The SEC is investigating, but my understanding is that the main group of individuals trading GameStop, those using the Reddit WallStreetBets social media forum, did not make material false or misleading statements and were not deceived by others.

For securities manipulation, a person needs to create a false impression of buying or selling activity. The Supreme Court has said that manipulation is "virtually a term of art when used in connection with the securities markets."[1] Manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[2] Some important legal authorities have taken broader approaches,[3] but the essence of a manipulation is buying or selling activity that is not legitimate or genuine.

The traders using the WallStreetBets site actually bought GameStop and the other stocks. If a person bears market risk, that is, a non-trivial risk that the buyer or seller will make or lose money on the transaction, then the person did not engage in artificial trading even if he or she had evil intent. In addition, when a person actually buys stock, it is very hard to tell the difference between evil intent to manipulate the stock price up and a person's desire for the stock price to go up naturally.

The effects of the GameStop trading on the larger secondary market for securities do not, at the moment, appear to be widespread or severe. The trading activity in GameStop, AMC, and Blackberry was limited to a few companies and was short term. Some investors made money in GameStop and some lost money. Short sellers of GameStop might have a legitimate complaint about the WallStreetBets buyers, and the short sale rules in the securities laws could be reviewed, but those rules were not the major cause of the price increases. The sharp rise and fall in the price of GameStop did not have apparent effects on broader market gauges.[4] Even if an index fund or an exchange traded fund owned GameStop, that holding was only one name in a diversified portfolio, and the price of GameStop stock began to correct itself within a short time with no significant damage to the pricing or liquidity in the more general market for listed equities.

I do not want to sound like I encourage the behavior of the WallStreetBets traders. I do not. The actions of the GameStop buyers were not consistent with the purpose of the federal securities markets. The purpose of the securities markets is to allow companies with good ideas to raise capital and to let millions of investors buy and sell existing shares based on their assessment whether companies have good commercial ideas or not.

My understanding is that the WallStreetBets crowd was engaged in group behavior that was in part to stymie some short sellers, in part to identify with the other members of the group, and in part to have some entertainment. Most were not buying and selling GameStop based on an assessment of the likelihood of profit at the company (although some were), but those buying without analysis of the fundamental value of the retailer knew what they were doing, were not misled, and knew they could lose money. As discussed below, the events surrounding GameStop do not appear to require new securities restrictions or regulation.

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1. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976).
2. Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 476-77 (1977); see also Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 6 (1985).
3. See, e.g., Markowski v. SEC, 274 F.3d 525 (D.C. Cir. 2001).
4. Anneken Tappe, US stocks post their worst month since October as the GameStop frenzy rages, CNN Business (Jan. 29, 2021) (reporting that, in January 2021, the month of the GameStop increase, the Dow and the broader S&P 500 had their worst month since October), https://www.cnn.com/2021/01/29/investing/dow-gamestop-stock-market-today/index.html. Data from Google Finance show that GameStop went up 1784 percent in January 2021 while the S&P 500 index went up 0.4 percent and the Russell 2000 index, which included GameStop at the time, went up 6.6 percent.

ROBINHOOD

The broker-dealer Robinhood has come under scrutiny because many of the WallStreetBets traders use it and because it has certain features that encourage buying and selling securities. Those features include commission free trades, accounts with no minimum dollar amounts, the availability of option trading and fractional shares of stock, and an ability to buy and sell securities on an attractive, easy-to-use internet site. Some have called the Robinhood mobile app the "gamification" of securities trading.

The criticisms of Robinhood fail to give appropriate weight to the benefits of its business model. The Robinhood brokerage service is innovative and makes significant positive contributions to society and the economy. It reduces costs for consumers, makes securities trading simpler and easier, increases consumer choice, and lowers barriers to participation in the market for the common stock of companies listed on stock exchanges. It therefore opens the securities markets and equity securities ownership to a much larger part of the population and to people with less income and wealth than those who are typically associated with participation in the equity markets.

Expanding access to the equity securities markets for many new retail investors is especially notable. It is directly responsive to the concern that direct ownership of corporate stocks by individuals has declined since World War II.[5] It is also directly responsive to the desire to make exchange-listed securities more accessible to lower income people and to give them more opportunities to increase wealth.[6]

Robinhood therefore increases consumer welfare and achieves important objectives of the U.S. economic and financial system. All of this is commendable and should not be faulted.

Another question about Robinhood was the decision to restrict the ability of its customers to buy GameStop and other securities for a short period of time. In his testimony before the House Financial Services Committee on February 18, 2021, the head of Robinhood explained the circumstances leading to the restrictions. Robinhood received an unexpected call for a large amount of collateral from a financial institution that is the clearinghouse for the trades of Robinhood customers. The restriction on the purchases of GameStop was part of the response because Robinhood was not able immediately to provide the requested collateral. Robinhood explained that it did not restrict customers because of a desire to help short sellers or its main wholesale broker.

CONSIDERATIONS FOR FURTHER ACTION

The events surrounding the changes in prices for GameStop and the questions about the Robinhood trading platform have so far not revealed the kind of problem that would justify new legal restrictions or regulations. New regulation would be appropriate if data and evidence emerge to show a severe, sustained, recurring harm to investors that a law could prevent or reduce. We have not seen such a harm yet, but the more detailed investigations being undertaken could produce evidence of misconduct or reasons to reconsider the need for new regulation.

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5. Kristian Rydqvist et al., Government policy and ownership of equity securities, 111 J. Fin. Eco. 70, 71 (2014) ("Since World War II, household direct equity ownership has declined precipitously. In the United States, just after the war, households directly own 90% of the stock market; by 2010, this figure has come down to below 30%.").

6. The United States has made progress increasing household ownership of securities when both direct ownership and indirect ownership are considered. Indirect ownership means ownership of corporate equities through mutual funds or retirement plans. The percent of U.S. households owning stock directly and indirectly grew from approximately 32 percent in 1989 to 53 percent in 2019. When indirect ownership is taken into account, all income groups from the lowest to the highest quintile of family income increased stock ownership. This information is from a report of the Investment Company Institute that summarized the Federal Reserve Board's 2019 Survey of Consumer Finances. See Sarah Holden & Michael Bogdan, Main Street Owns Wall Street, ICI Viewpoints (Feb. 10, 2021), https://www.ici.org/pdf/21_view_equityownership_print.pdf.

Congress and the SEC should not impose new regulations lightly. An important consideration should be that government rules typically restrict personal freedom. The GameStop traders might not have been analyzing the fundamental financial position of GameStop within the traditions of the capital markets, but they were exercising their individual civil liberty. A founding principle and continuing aspiration of the country has been to preserve personal freedom, extend it when it has been denied, and use government regulation only when a serious and widespread harm is recurring. If regulation is justified, it should be narrow and go no further than necessary to correct the harm.