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Robinhood and GameStop:
Essential issues and next steps for regulators and investors

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The hullabaloo surrounding the run up in the price of GameStop (GME) and the activities of Robinhood have generated front page news, calls for action, and allegations of wrongdoing. However, lost in the headlines and struggles between good and bad or big and little is the issue that should be of greatest concern – financial stability.

Critical issues for regulators and investors fall into two broad related categories. They are 1) macro risk management and crisis prevention and 2) micro regulatory issues. Macro financial conditions pave the way for micro actions and distortions.[1] For instance, many view the housing and mortgage sector as the cause of the Global Financial Crisis in 2008 rather than acknowledging the extended period of ease monetary policy fueling the financial flames.[2]

- **As to risk management and crisis prevention, events surrounding Robinhood and GameStop may be the first shot across the bow regarding deeper and more systemic financial market risks.** Seemingly idiosyncratic risks in early 2007 unveiled fault-lines that ultimately unleashed the Global Financial Crisis in 2008. In retrospect, HSBC's subprime mortgage unit problems on February 8, 2007 and Bear Stearns' bailout of two troubled hedge funds on June 22, 2007 were meaningful early warning signs of stress.

  For a longtime, the Center for Financial Stability (CFS) has been clear regarding the role of monetary policy in growing financial excess and distortions.[3]

- **As to regulatory issues, certainly, the SEC and other financial regulators should investigate.** What regulatory action should be taken regarding investors or regulatory intermediaries is less clear. It is important that neither Congress nor the regulators make changes to the markets without understanding all dimensions of the problem and making sure the changes address the fundamental problem. Regulations can create

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[1] Aliber, Robert Z. and Charles P. Kindleberger, Manias, Panics, and Crashes: A History of Financial Crises, 7th Edition, Palgrave Macmillan, 2015.
[2] In the 545 page Financial Crisis Inquiry Report, there is no mention of the role of monetary policy – see The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, Perseus Books Group, January 2011 - https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.
[3] Goodman, Lawrence, Why CFS Divisia Money Matters, Now!, Remarks at The Society of Economic Measurement Conference, Thessaloniki, Greece, July 8, 2016 - http://centerforfinancialstability.org/research/why_cfs_divisia_071316.pdf

new unexpected situations, and perhaps even bigger problems. Technology and new manners of interaction create new situations and regulatory challenges that may interact in unexpected ways with regulatory change that is not fully considered.

To be sure, regulators and investors alike need to devise a strategic plan to investigate last week's unusual events. Misinformation abounds and many misunderstandings exist. A start is to 1) understand essential issues – what happened and why, as well as 2) propose next steps.

Essential Issues

The SEC and Federal Reserve would benefit from a more thorough evaluation of the financial market implications from varying policies implemented over the last 13 years. These policies have created an environment of abundant monetary liquidity that has led to distortions across markets and firms supervised by official and industry self-regulatory organizations.[4] In the specific instance of GameStop, monetary liquidity via Quantitative Easing (QE) exercises and near zero interest rates have favored momentum investments and investors.[5] In other words, once the price of GameStop started to appreciate, it was easy for the shares to skyrocket.[6]

An understanding of arcane mechanics is more important than ever for smooth operation of the financial system – especially within the context of the present policy mix. The run-up in the value of GameStop coupled with stressors in clearing trades at Robinhood spring from complexities and operational mechanisms in financial institutions. These shifts are becoming increasingly pronounced since early 2007 with gapping in the LIBOR-OIS spread, counterparty risk difficulties in 2008, and complications in the U.S. Treasury repo market in 2020.

There is also a significant misunderstanding on the part of retail investors or traders who are "outraged" at Robinhood for seizing and limiting trading in GameStop and a few other securities. Many new investors expect that online broker/dealers operate in an unregulated fashion, more like a shopping service. Thus, there is limited appreciation for the fact that capital, liquidity and other requirements by regulators and central counter parties may from time to time impede these companies from accepting an unlimited volume of trades.

As a legal matter, a broker-dealer does not generally have an obligation to accept a trade for execution, even if it must execute the trade promptly once it has been actually accepted for trading. It seems that Robinhood promptly rejected trades that it did not want to execute.

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[4] Goodman, Lawrence, "Crisis Detection and Prevention: Implications for Investors and Officials," Remarks at the Boston Economic Club, Center for Financial Stability, March 23, 2016 - http://www.centerforfinancialstability.org/speeches/Boston_032316.pdf.

[5] Bair, Sheila and Lawrence Goodman, Corporate Debt 'Relief' Is an Economic Dud, *The Wall Street Journal*, January 6, 2021 - https://www.wsj.com/articles/corporate-debt-relief-is-an-economic-dud-11609975810.

[6] This a familiar market pattern. Recall the program insurance contribution to the sudden equity crash of 1987. Rather than providing a hedge against market downturns, program insurance was a simple momentum follower. In effect, swift market stumbles fueled even more selling.

Broker-dealers by definition act as intermediaries between buyers and sellers; their revenue comes from successful matching of counterparties on opposite sides of a trade. The massive volume of trading on one side (buying) of a volatile security would create real credit risk for Robinhood, and for the Depository Trust & Clearing Corporation (DTCC) as the clearing house, while the trades were unsettled; so it is not surprising that Robinhood sought to limit this credit risk. Regulators will need to consider whether capital requirements adequately account for the risks created by unsettled trades. Regulators should also be concerned that the authority of the registered clearing agencies to call on their members for the immediate delivery of wholly unexpected amounts of collateral may keep the clearing agencies safer but creates significant systemic risks elsewhere in the system, and drains on liquidity.[7]

In many ways, the migration of financial activities to non-bank financial institutions presents new and less well understood risks. These trends and challenges are enhanced by an industrial battle between technology and finance. Regulators seem distressed at the rapid growth of trading at Robinhood – a non-traditional (tech-based) securities firm. In many ways, regulators created the system in which the offering product of full-service brokerage firms was rendered less competitive, so that investors moved their accounts to firms offering a lower cost of trading and in conjunction derived more of their information from social media rather than traditional regulated entities.

Similarly, technology should now facilitate a move from two-day clearing and settlement to one or potentially even to zero.[8]

Another battle between retail investors and Wall Street needs to be disentangled into components:

- **First, there is truth to existing and rising inequalities.** In recent months, market gains have seemingly been a partial equalizer for some. Retail ownership in corporations through the purchase of shares is generally beneficial over the long-run. However, it also comes with risk.

  From a financial markets' perspective, retail investor participation is also beneficial. It creates a number of atomized agents providing hopefully unique stimuli and insights to create a more effective and efficient market. However, forces driving market prices are complex. A good story and table pounding are insufficient to generate consistent gains over the longer term. Hence, financial education is imperative.

[7] Roberts, Jeff John, The real story behind Robinhood's decision to restrict GameStop trading—and that 4 a.m. call to put up $3 billion, Fortune, February 2, 2021.
[8] Wetjen, Mark, The Risks and Rewards of DLT, Engaging Industry, Advancing Innovation, DTCC, June 20, 2019 - https://www.dtcc.com/dtcc-connection/articles/2019/june/20/the-risks-and-rewards-of-dlt

But not everyone has become a retail investor. Recent figures show that just over half (53%) of all families in the US owned stocks, and less than a third (31%) of those families in the bottom half of the income distribution.[9] Thus, a large swath of the population has not enjoyed the benefits of retail ownership.

- **Second, a popular misunderstanding – that retail investors are uniquely positioned to inflict damage on hedge funds – is actually a mirage.** Some retail investors are dangerously and perhaps prematurely declaring victory over hedge funds. They are missing the point that hedge funds are sophisticated investors. They maintain multiple investment positions, which stretch across many firms, asset classes, and countries. So, if one hedge fund loses on a concentrated investment position, others may be immune to losses and still others may benefit mightily. And so, it may ultimately be those with less wealth, i.e., fellow small retail investors who are losing.

  In the case of GameStop, it appears that retail investors successfully surprised the hedge funds selling short. But in the future, it is likely that element of surprise will be gone. Hedge funds will monitor investment sentiment on social networks just as they now monitor credit card spending and the unemployment rate. Social media investment sentiment will become just one more factor to be considered in investing, and hedge funds will be able to quantify the value of that factor at least as well as can retail investors.

- **Third, hedge funds or other investors that implement short positions aren't necessarily the enemy and are often friends of retail investors.** Short selling gives investors a means to profit from a negative view, and thus to investigate issues where there may be a problem.[10] For example, firms that engage in short selling have an incentive to uncover and disclose fraud at an issuer. That said, short selling is risky, as prices can rise without limit and short sellers can lose an unlimited amount. Further, short sellers are potentially vulnerable to a squeeze, as in the case of GameStop. Regulatory action that makes short sellers more vulnerable, and drives them from the market, can be expected to have a materially adverse effect on the incentive to gather information, as there will be no incentive to profit from obtaining hidden negative information, such as the kind that can be exposed as fraud.

Social activity and communication among retail investors is not new. History is laced with many examples of questionable advice from Bernard Baruch's famous story before the Great Depressions to sell when his shoeshine boy was offering stock tips to the many stock chat

[9] Bhutta, Neil, et al, "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," Federal Reserve Bulletin Vol. 106, No. 5, Septemper 2020, Box 5 (page 18) - https://www.federalreserve.gov/publications/files/scf20.pdf

[10] Gruenewald, Seraina N., Alexander F. Wagner, and Rolf H. Weber, Short Selling Regulation after the Financial Crisis - First Principles Revisited, International Journal of Disclosure and Regulation, Vol. 7, No. 2, pp. 108-135, July 27, 2009 - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439652.

rooms active before the severe 2000-2002 NASDAQ internet stock correction. Yet, in some instances, unregulated communication may be accurate and helpful. For example, the initial July 2020 webcast on the case for GameStop by "Roaring Kitty" appears quite well-researched. Roaring Kitty comes across in his webcast as smart, self-effacing, thoughtful, well-educated, and reflective – buying GameStop stock based on the market, balance sheet, and management fundamentals.[11]

However, technology and communication tools are better able to link more people across geography more rapidly than ever before with uncertain consequences for financial markets. For instance, one of the outstanding questions is where the regulatory line should be drawn between expression of opinion and misleading communications when securities markets are involved. Registered broker/dealers, and their employees with the authority to speak with clients, are licensed and held to quite specific rules about what can be communicated, including over social media, and what must be included when doing so. In contrast, unregistered individuals with internet followings cannot be held to the same standards of behavior. However, this gives rise to the possibility of social media being used to facilitate "pump and dump" schemes, a very difficult area for the SEC to police.

Similarly, the question exists whether more linkage and greater communication means that the quality of information is any better – and perhaps it could be worse?

Next Steps for Regulators and Investors

- What are the lessons from GameStop and Robinhood for financial stability?

- The Federal Reserve, CFTC, and SEC should investigate the impact of abundant monetary liquidity on regulated markets and institutions. Within the context of any investigation, officials should seek to understand the etiology of why we are here. What financial market distortions exist? How does policy and regulation potentially reduce the impact of these distortions and safeguard the system?

- Can dynamic margin requirements minimize risks while preserving growth and investment opportunities? Similarly, can technology improve settlement times and minimize market risks?

- Education is imperative. Perhaps the CFPB and the SEC should offer more online courses in investment and the risks inherent in investor activity? Course creation might be more engaging and benefit from being crowdsourced – where a contest would be held to produce entertaining yet content rich online resources. In the aftermath of the

[11] Gill, Keith, aka Roaring Kitty, Initial GameStop Recommendation, July 2020 -- https://www.reddit.com/r/videos/comments/l7hutc/the_original_analysis_by_reddit_user/.

GameStop run up, the SEC produced a warning piece against investing in "hot stocks."[12] While reasonable and well-intentioned, the warning piece is simply not going to reach or hold the attention of the desired audience.

- Exercise extreme caution regarding blaming or inhibiting short sellers. They provide substantial benefits to the market and should not be the scapegoats whenever market disruptions occur.[13]

- The SEC should consider how to best monitor social media via new artificial intelligence (AI) and natural language processing (NLP) to prevent abuse and pump and dump schemes.

- The SEC should consider whether some of its regulations intended to protect retail investors actually have a negative effect. For example, the SEC, should consider whether the intense regulation of research has had the effect of depressing the production and dissemination of research to retail investors, forcing them to rely on social media as the only meaningful available information source. Additionally, they should consider whether Regulation Best Interest may diminish information provided thus causing broker-dealers to withdraw from providing "full service brokerage" (recommendations) to smaller retail investors, again motivating them to move to unregulated social media as their information source.[14]

Concluding Thoughts

For regulators trying to get in front of the GameStop situation, much of the discussion seems to be centered on the question of when does a group of atomized agents become a destabilizing, colluding, market-manipulating mass, in need of regulation? We see this all too often – that the response to destabilizing market events is one of more regulation. But this is not the only response possible and **it is important for policymakers to think about the broader financial stability implications of their actions.**

There is not a level playing field. Leaving aside the question of whether there should be, or what, if anything, should be done about this recent event, it's important to recognize the broader financial stability issues that go beyond this one incident. Inequalities in the retail sector exist that hinder participation and leave large portions of the population behind. **But yet with increased access comes a need for increased accountability and responsibility.**

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[12] https://www.sec.gov/oiea/investor-alerts-and-bulletins/risks-short-term-trading-based-social-media-investor-alert

[13] Boehmer, Ekkehart, C.M. Jones, and X. Zhang, "Shackling the Short Sellers: The 2008 Shorting Ban," Review of Financial Studies 26(6), June 2013 - https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1412844.

[14] Lofchie, Steven, Choose One: Best Interest or Full Service, Cadwaladar, April 26, 2018 - https://www.cadwalader.com/resources/clients-friends-memos/choose-one-best-interest-or-full-service.

Such themes point to a vital recommendation: More financial education is needed. This is a topic that the Center for Financial Stability has championed from research to events to a summer intern program – which was motivated by a short CNBC video vividly illustrating the magnitude of challenges to young adults during the pandemic.[15]

Regulation faces a key policy conundrum. Rather than leaving it to officials that after-the-fact swoop in and regulate so that the last crisis doesn't happen again, it is imperative to educate market participants about risk identification and mitigation.

Here, Harvard Professor and economic advisor to President Kennedy, John Kenneth Galbraith summed it all up by noting that:

> **"Regulation and more orthodox economic knowledge are not what protect the individual or financial institution when euphoria returns." …**
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> **"There is protection only in a clear perception of the characteristics common to these flights into what must conservatively be described as mass insanity."**[16]

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[15] https://www.cnbc.com/2020/05/22/new-college-grads-are-having-their-job-offers-rescinded.html.
[16] John Kenneth Galbraith, A Short History of Financial Euphoria, Penguin Books, 1990.