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corporate disputes

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REPRINTED FROM:
CORPORATE DISPUTES MAGAZINE
APR-JUN 2021 ISSUE

www.corporatedisputesmagazine.com

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PERSPECTIVES

THE QUICK SHORT SQUEEZE: LEGAL ISSUES SURROUNDING THE GAMESTOP TRADING FRENZY

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As online traders sent GameStop stock soaring and short sellers faced unprecedented losses, several online trading platforms, most notably Robinhood, restricted trading. Those trading restrictions sent lawyers scrambling to court, launching nearly 50 competing class action lawsuits, alleging a host of claims, but primarily market manipulation in violation of the Securities Exchange Act of 1934 and breach of contract. The restrictions also led to calls for investigations from members of Congress and state attorneys general. But were any laws broken, regulations violated, or agreements breached? The short answer is maybe.

First, with respect to short sellers, while short selling is banned in some countries, it is a widely accepted trading strategy in the US, regulated by the Securities and Exchange Commission (SEC). And while the SEC has temporarily halted some short selling at certain times, most notably during the 2008 financial crisis, it places few permanent restrictions on the practice. So, by almost any measure, the short position in GameStop was unremarkable: GameStop is a declining brick-and-mortar retail store operating

in an industry that has been moving toward digital transactions, and its stock price had been in a steady decline for years.

Second, with respect to GameStop investors, those investors' sudden interest in GameStop stock was surprising to many. As institutional investors holding short positions saw the potential for billions in losses, CNBC's Jim Cramer declared, "The mechanics of the market are breaking down." But, like short selling, there are few restrictions on a retail investor's purchase of stock. Investors are free to make any purchases they see fit and for any reason. Thus, those retail investors' trades, while seemingly counterintuitive, do not raise any legal red flags. That is true, even where those investors banded together to make purchases and even where those purchases cause the stock price to rise precipitously, forcing some short sellers to close their positions and lose money to forestall even greater losses in a short squeeze.

It is possible that some more sophisticated traders engaged in market manipulation – a subject currently under federal investigation. Section 9(a)(2) of the Securities Exchange Act of 1934 makes it illegal for anyone, alone or in a group, to intentionally distort the market for a security, though the SEC generally also requires some type of fraud or false statement before charging that conduct. If any traders were pushing false information to intentionally drive GameStop stock up, looking to profit, that would resemble a classic pump-and-dump scheme and could be charged as market manipulation.

Still, the First Amendment of the US Constitution protects free speech, which includes retail investors' rights to discuss their opinions on stock and to band together. Without some clear indication of fraud or false statements of fact, it is very unlikely that investors will be charged simply for banding together to make trades – even if those investors made their purchase with the intent to help the stock price rise or with the intent to hurt short-sellers. So far, no clear fraud or false statements have come to light.

And most public statements by GameStop investors were transparent about their objectives. Reddit posts calling for investors to buy more GameStop shares made no claims, true or false, about GameStop's business and were instead largely humorous and focused on the absurdity of GameStop's sharp rise and the novelty of pitting retail investors against sophisticated funds. So, unless investigators uncover new information, the trading frenzy surrounding GameStop, and the traders involved in it, violated no clear laws or regulations.

Third, with respect to Robinhood and other trading platforms, their decision to restrict trading has drawn perhaps the greatest amount of ire and scrutiny – it has certainly generated the greatest number of lawsuits. As trading was halted, investors suspected some form of market manipulation, and theorised that the trading platforms were colluding with short-selling hedge funds to drop the price of GameStop and other heavily shorted stocks. Elected officials demanded answers and promised investigations. And lawyers rushed to court, asserting claims ranging from market manipulation to breach of contract and negligence.

Robinhood's official explanation for its decision to suspend buying is relatively straightforward. Due to market volatility, clearinghouses substantially increased the deposit requirement for brokerages like Robinhood, whose customer base traded heavily in volatile stock, like GameStop. Robinhood had to limit trades in order to meet that deposit requirement and execute any trades at all. And that clearinghouse demand was, likewise, tied to market risk. Because the market for GameStop was volatile, the clearinghouse needed additional collateral to protect its reserves, ensuring its ability to continue to settle and clear trades.

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The lawsuits against Robinhood are in their early stages, but they face significant hurdles. For example, in the first high-profile ruling in one of those suits, *Cobos v. Robinhood Financial LLC*, the Central District of California denied the plaintiff's request for a temporary restraining order that would prohibit Robinhood from restricting trading on its platform. To be entitled to a temporary restraining order, the plaintiff needed to show, among other

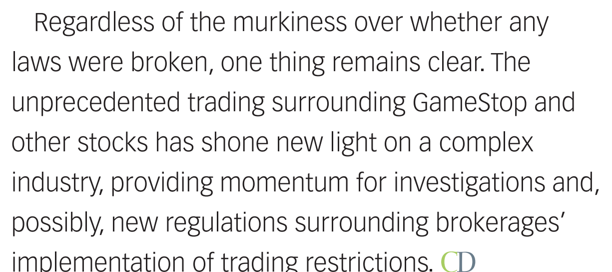
things, a likelihood of success on the merits of his case.

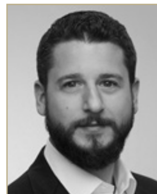
The court's order made clear why the plaintiff is unlikely to succeed on his market manipulation claim: to succeed on his claim, the plaintiff would need to demonstrate: (i) that he purchased or sold securities at a price that was affected by the alleged manipulation; and (ii) that Robinhood took action to mislead investors to induce them to trade in those securities. The plaintiff argued that Robinhood's trading restrictions blocked him from purchasing stock. He further argued that those trading restrictions, which largely restricted purchases but not sales of stock, were designed to make the stock prices fall. But as the court reasoned, the plaintiff's grievance was not that he purchased or sold stock at a manipulated price. Rather, his claim was that Robinhood's restrictions prevented him from buying certain stock (though he was free to buy that stock through other trading platforms).

The court also reasoned that Robinhood took no action intended to mislead investors and made no false or fraudulent statements. In fact, it did the opposite – preventing trades in those securities. Based on the court's analysis, Robinhood's trading restrictions would not constitute market manipulation, even if those restrictions could affect a stock's market.

The suits alleging breach of contract are likely to face similar uphill battles. Brokerages, like Robinhood, are given broad discretion to halt or limit trades and reserve broad rights in their user agreements. Here, Robinhood has presented a facially plausible reason for restricting trades and is protected by language in its user agreement. But it still could be argued that Robinhood has applied its restrictions inequitably by restricting users executing one trading strategy (purchases) but not restricting users executing other strategies – violating the covenant of good faith and fair dealing implied in all contracts. Whether those claims will see more success than market manipulation claims remains to be seen.

Regardless of the murkiness over whether any laws were broken, one thing remains clear. The unprecedented trading surrounding GameStop and other stocks has shone new light on a complex industry, providing momentum for investigations and, possibly, new regulations surrounding brokerages' implementation of trading restrictions. CD





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