MAXINE WATERS, CA
CHAIRWOMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

PATRICK MCHENRY, NC
RANKING MEMBER

February 15, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: February 18, 2021, Full Committee Hearing entitled, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide"?

The full Committee will hold a virtual hearing entitled, "Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide" on Thursday, February 18, 2020 at 12:00 pm Eastern Daylight Time on the virtual meeting platform Cisco Webex. There will be one panel with the following witnesses:

- **Keith Gill**
- **Kenneth C. Griffin**, Chief Executive Officer, Citadel LLC
- **Steve Huffman**, Chief Executive Officer, Co-Founder, Reddit
- **Gabriel Plotkin**, Chief Executive Officer, Melvin Capital Management LP
- **Vladimir Tenev**, Chief Executive Officer, Robinhood Markets, Inc.
- **Jennifer Schulp**, Director of Financial Regulation Studies, Cato Institute

I. Overview

In January 2021, retail investors on social media site Reddit's "WallStreetBets" subchannel ("subreddit") collectively executed an investment strategy to induce a short squeeze in stocks such as GameStop, AMC and KOSS, as well as other securities they identified as being heavily shorted by hedge funds. Meaning, social media users collectively drove the stock prices up, forcing short sellers who bet the stock price would go down, to purchase shares at an increased price. Reddit user, Keith Gill, notoriously discussed GameStop stock on Reddit under the username "DeepF*ckingValue." Initially, this squeeze led to heavy losses for some short sellers, particularly hedge funds, and led to substantial financial gain for some retail investors. Robinhood, and other broker dealers, placed restrictions on transactions in these stocks, which received public and regulatory scrutiny. Eventually, the stock prices started to decline and many investors were faced with steep financial losses. For some, the January short squeeze raises questions regarding whether legislators and regulators should take a closer look at existing rules governing short sales and related disclosures, as well as the conflicts between the practice of payment for order flow and firms' best execution obligations. It also raises important questions about the efficacy of anti-market manipulation laws and whether technology and social media have outpaced regulation in a manner that leaves investors and the markets exposed to unnecessary risks.

II. Short Selling

When an investor shorts a stock, they borrow the stock, typically from a broker, and then sells it to another investor.[1] When the time comes for the borrower to return the borrowed stock, the borrower will purchase the stock in the market and return the stock to the lender.[2] In a successful short sale, the market price of the borrowed stock will fall below the amount it costs to borrow the stock. When this happens, the borrower is then able to purchase the stock in the market at an amount lower than it cost the borrower to borrow the stock, return the stock to the lender, and keep the difference as profit.[3] Some investors, such as hedge funds, engage this trading strategy when they are betting that the price of the securities will decline and expect they can profit from that decline.[4] Others use this strategy to hedge against other market risks.[5] The U.S. Securities and Exchange Commission (SEC) has repeatedly noted that short selling provides liquidity and price efficiency.[6,7] The SEC has, however, implemented various rules to curb *abusive* short sale practices. These are discussed below, in detail.

III. Short Sale Rules and Laws Against Fraud and Market Manipulation

A. Regulation SHO

On July 28, 2004, the SEC adopted a new Regulation SHO, under the Securities Exchange Act of 1934 (Exchange Act), which implemented changes in how short sales are regulated.[8] One important function of Regulation SHO is that it restricts short sales that are referred to as "naked short sales."[9] Generally speaking, a naked short sale refers to selling short without having first borrowed the stock.[10]

It is important to note that naked short selling does not always violate Regulation SHO.[11,12] In fact, the SEC has noted that, in certain circumstances, naked short sales may contribute to market liquidity.[13] For instance, broker dealers that are market makers provide liquidity to the market by being ready to buy or sell a security, even in the absence of a buyer or seller, and even when there are market shortages.[14] Due to the time it can take to buy or borrow a security, a market maker may short a security without first making arrangements to borrow it.[15]

Later, in 2010, the SEC amended Regulation SHO to include the alternative uptick rule.[16] The alternative uptick rule places restrictions on short selling during periods where a stock's price significantly declines.[17] More specifically, the rule restricts short sales on certain securities

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1 SEC, Fast Answers, Short Sale Restrictions (available at https://www.sec.gov/answers/shortrestrict.htm#:~:text=A%20short%20sale%20is%20the,the%20account%20of%2C%20the%20seller, as of Feb. 3, 2021); *see, also* Amendments to Regulation SHO and Rule 10a-1, 71 FR 75068, 75069-75070 (Dec. 13, 2006) (available at E6-21156.pdf (govinfo.gov), as of Feb. 3, 2021).

2 *Id*.

3 *Id*.

4 *Id*.

5 *See* Sherman & Sterling. *SEC Regulation SHO Takes Effect, Implementing a Mixed Bag of Changes to Short Sale Rules*. (Mar. 2005).

6 Federal Register. *Amendments to Regulation SHO and Rule 10a-1, 71 FR 75068, 75069-75070*. (Dec. 13, 2006).

7 Securities and Exchange Commission. *SEC Approves Short Selling Restrictions*. (Feb. 24, 2010).

8 Securities and Exchange Commission. *Short Sales, Release No. 34-50103; File No. S7-23-03*. (Jul. 28, 2004).

9 *See, generally, id*.

10 *Id*. at fn. 10.

11 17 CFR § 242.203(2)(iii)

12 Securities and Exchange Commission. *Key Points About Regulation SHO sec. II*. (Last accessed Feb. 8, 2021).

13 *Id*.

14 *Id*.

15 *Id*.

16 Securities and Exchange Commission. *SEC Approves Short Selling Restrictions*. (Feb. 24, 2010).

17 Securities and Exchange Commission. *Amendments to Regulation SHO, Release No. 34-61595; File No. S7-08-09*. (Feb. 26, 2010).

that experience a 10% or more price decrease in a single day.[18] In these cases, short sales are only permitted where the price is above the current best bid.[19]

B. Fraud and Market Manipulation

U.S. securities laws prohibit fraud and market manipulation. Violations of these laws typically involve two categories of misconduct: (1) the spread false information in order to affect the price of a security, including pump-and-dump schemes; and (2) schemes in which bad actors individually or collectively transact to create false levels of volume or manipulate the price of a stock.

(i) Section 17(b) of the Securities Act of 1933

Section 17(b) of the Securities Act of 1933 makes it unlawful for a person to "tout", or publicize, a stock without discussing the nature of any payments or other consideration the person has been, or will be, paid.[20]

(ii) Section 9(a)(2) of the Exchange Act

Section 9(a)(2) prohibits transactions that directly or indirectly create actual or apparent active trading to induce the purchase or sale of a security by others.[21] While Section 9 of the Exchange Act prohibits manipulation of securities prices, it requires the demonstration of specific intent "for the purpose of inducing the purchase or sale of such security by others" or "for the purposes of creating a false or misleading appearance of [market activity]."[22]

(iii) Rule 10(b)(5) & FINRA Rule 2020

Rule 10b-5 makes it unlawful to "employ any device, scheme, or artifice to defraud", make material statements that are false or to omit material facts, or to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[23] To successfully establish a 10b-5 manipulation claim, the plaintiff must show that "(1) the defendant made a material misstatement or omission or used a fraudulent device; (2) she did so with scienter (that is, intent); (3) her conduct was related to the purchase or a sale of a security; (4) the plaintiff relied on the misstatement; and (5) the plaintiff was harmed."[24] Rule 10(b)(5) is very broadly applied in various types of manipulation practices, including "marking the close," spoofing, scalping, etc. This is because "under Rule 10b-5, the fraudulent conduct alone can be indicative of the manipulator's deceptive intent."[25] Similarly, FINRA rule 2020 prevents FINRA members from making sales or purchases through manipulative, fraud or deceit.

C. Dodd-Frank Wall Street Reform and Consumer Protection Act

Section 929X(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the Commission to "…prescribe rules providing for the public disclosure of the name of the issuer and the title, class, CUSIP number, aggregate amount of the number of short sales of each security, and any additional information determined by the Commission

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[18] *Id*.
[19] *Id*.
[20] 15 U.S. Code § 77q (b).
[21] 7 U.S.C. § 9 (2)
[22] 15 U.S.C.A. § 87 (2000).
[23] 17 CFR § 240.10b-5
[24] *See* Gina-Fail S. Fletcher. *Legitimate Yet Manipulative: The Conundrum of Open-Market Manipulation*. (2018).
[25] Arnold & Porter. *Criminal and Regulatory Enforcement of Market Manipulation Spikes.* (Jul. 21, 2016).

following the end of the reporting period. Pursuant to section 929X(s), at minimum, such public disclosure shall occur every month."[26] Section 929X(a) also instructed that this reporting should occur, at minimum, on a monthly basis.[27]

However, FINRA Rule 4560 requires broker dealers to maintain a record of, and to report, certain short positions in customer accounts.[28] Also, in 2010, the SEC adopted Rule 613 to create a repository for trade and data information for national market system securities, including recording certain short sale information.[29] Notwithstanding, the existence of these reports, and the ongoing implementation of the repository, the SEC has not completed rulemaking under Section 929X(a) of Dodd Frank.

IV. The Short Squeeze

In January 2021, investors collectively established a strategy to achieve what is known as a "short squeeze" on stocks that had been heavily shorted, particularly by hedge funds, such as GameStop, AMC and others. A short squeeze occurs when the market price of shorted stock rises above the price at which the stock was borrowed, forcing short sellers to purchase the stock at a higher price. The short squeeze of GameStop's stock, for example, resulted in tremendous volatility in its pricing and, at one point, led to a 600% surge in the stock price.[30] Much of the strategizing occurred on WallStreetBets, a Reddit subchannel (or "subreddit") where approximately 8.5 million users[31] discuss trading ideas and investment strategies, including retail investors.[32]

Amidst the squeeze, Robinhood Financial LLC, and other financial firms, placed restrictions on transactions in certain securities.[33] Some speculated that Robinhood's decision to restrict trading resulted from a business relationship between Robinhood, Citadel, and Melvin Capital.[34] In particular, Robinhood routed orders to Citadel for execution and received a payment.[35] The practice, referred to as "payment for order flow," has been Robinhood's largest source of revenue since the firm's inception.[36] In December 2020, the SEC charged Robinhood with making misstatements about the firm's receipt of payment for order flow and for failing to comply with its duty to ensure that customer trades were executed on the best possible terms.[37] Robinhood's failure to satisfy it best execution obligations resulted in more than $34 million in aggregate customer losses. [38] Robinhood was censured and agreed to pay $65 million to settle the action.[39]

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[26] *See* Pub. L. No. 111-203, § 929X(a). (Codified as amended at 15 U.S.C. § 78m(f)(2). (2012)).
[27] *Id*.
[28] FINRA Rule 4560.
[29] 17 CFR § 242.613.
[30] *See* CNBC. *Stocks on the Robinhood restricted trading list like AMC and Koss surged on Friday* (Jan. 29, 2021). (Other stocks that were targeted by retail investors for a short squeeze include AMC, American Airlines, Blackberry, Bed Bath & Beyond, Koss Corp., Naked Brand, Nokia, Tootsie Roll Industries, and others).
[31] *See* Reddit. *WallStreetBets*. (Last accessed Feb. 4, 2021). (As of February 4, 2021, there are 8,534,728 users of the WallStreetBets subreddit, but that number may change as users subscribe or unsubscribe).
[32] Bloomberg. *Reddit Stocks: GameStop (GME) Rises in Premarket as Stock's Momentum Cools Down*. (Feb. 4, 2021).
[33] Wall Street Journal. *Robinhood, Other Brokerages Restrict Trading on GameStop, AMC*. (Jan. 28, 2021)
[34] Coin Telegraph. *Financial ties between Robinhood and funds shorting GME fall under scrutiny*. (Jan. 28, 2021).
[35] In Re Robinhood, SEC Admin. Pro., File No. 3-20171. (Dec. 17, 2020).
[36] *Id*.
[37] *Id*.
[38] *Id*.
[39] *Id*.

Melvin Capital Management LP reportedly sustained 53% in losses in January, but was able to end the month with $8 billion in assets due to investments made by Point72 Asset Management and Citadel.[40] The relationship between Melvin Capital, Citadel and Robinhood, as well as Robinhood's reliance on payment for order flow, caused public concern about whether the relationship contributed to Robinhood's decision to restrict transactions in certain securities.[41] Citadel denied any involvement in Robinhood's decision.[42] Robinhood issued a statement attributing the trading restrictions to expanding deposit requirements imposed by its clearinghouse.[43] While some hedge funds like Melvin Capital reported losses, hedge funds also profited on the short squeeze, with one hedge fund reportingly making $700 million.[44] During the week of February 3, 2021, however, GameStop's stock plunged from $483 to $90 in just one week, leaving some retail investors, potentially, facing hundreds of thousands in losses.[45] Those who lost money during this volatility include novice investors.[46]

V. Gamification and Social Media

Not surprisingly, before regulators could fully assess the current controversy, technology responded. A technology company developed a tool that gives hedge funds, and investment bank clients, the ability to track the most mentioned stocks on WallStreetBets.[47] In fact, some attribute the current controversy itself to the "gamification" of investing and to the increasing role that social media and technology play in capital markets.[48]

Gamification involves tactics used to engage customers to transact, such as increasing use of notifications, prizes, and other psychological tools and design elements to increase rapid trading and short-termism, instead of a more cautious approach. Robinhood in particular has been accused of using gamification to increase usage of its app, possibly to the financial detriment of its clients.[49] Examples include designs to appeal to younger users, including digital confetti to celebrate transactions, colorful illustrations, and its allowance for users to tap up to 1,000 times daily to improve their waitlist position for Robinhood's cash management feature.[50] This has led to criticism that gamified online trading platforms such as Robinhood encourage behavior similar to a gambling addiction.[51]

Regulators have expressed concern about Robinhood's investment platform. On December 16, 2020, Massachusetts regulators filed a complaint against Robinhood for its "aggressive tactics to attract inexperienced investors, its use of gamification strategies to manipulate customers, and its failure to prevent frequent outages and disruptions on its trading platform."[52]

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[40] Reuters. *Melvin Capital ends month with over $8 billion in assets after investors added cash*. (Jan. 31, 2021).
[41] Fox Business. *Citadel shoots down Robinhood link*. (Jan. 28, 2021).
[42] *Id*.
[43] Coin Telegraph. *Financial ties between Robinhood and funds shorting GME fall under scrutiny*. (Jan. 28, 2021).
[44] *See* Wall Street Journal. *This Hedge Fund Made $700 Million on GameStop*. (Feb. 3, 2021).
[45] *See* Washington Post. *GameStop stock plunge leaves newbie traders to reckon with heavy losses*. (Feb. 2, 2021).
[46] *Id*.
[47] CNN. *Wall Street is keeping very close tabs on WallStreetBets. Here's how*. (Feb. 3, 2021).
[48] *See, e.g.,* Washington Post. *Robinhood's Role in the 'Gamification' of Investing*. (Dec. 21, 2020).
[49] *Id*.
[50] Marker. *Robinhood Has Gamified Online Trading Into an Addiction*. (Jun. 23, 2020).
[51] NBC. *Gambling addiction experts see familiar aspects in Robinhood app*. (Jan 30, 2021).
[52] Commonwealth of Massachusetts Securities Division. *Administrative Complaint In the Matter of: Robinhood Financial, LLC*. (Dec. 16, 2020).