

## Testimony

Before the Committee on Financial Services, U.S. House of Representatives  
Hearing on “Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail  
Investors Collide”

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### Introduction

Chairwoman Waters, Ranking Member McHenry, and distinguished members of the Committee on Financial Services, my name is Jennifer Schulp, and I am the Director of Financial Regulation Studies at the Cato Institute’s Center for Monetary and Financial Alternatives.

I thank you for the opportunity to take part in today’s hearing entitled, “Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide.”

### Retail Investing

Before addressing the GameStop phenomenon specifically, I’d like to address the participation of retail, or individual, investors in our public equities markets.

Retail participation has ebbed and flowed over the years, but the recent trend toward increased retail participation accelerated sharply during the pandemic. Approximately one-fifth of market trading volume is now attributable to retail orders, which is a substantial increase over 2019.<sup>1</sup>

Most commentators point to the increasing availability of zero-commission trading as drawing in more individual investors. In late 2019, many large brokerages began offering zero-commission trading, following the lead of Robinhood Financial, which introduced commission-free trading in 2015. But several other factors also likely attracted retail investors, including the

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<sup>1</sup> Alexander Osipovich. “Individual-Investor Boom reshapes U.S. Stock Market.” *Wall Street Journal*, August 31, 2020. Available at <https://www.wsj.com/articles/individual-investor-boom-reshapes-u-s-stock-market-11598866200>; Piece Crosby. “Reflections on 2020 and What’s In Store for 2021: Through the Eyes of Retail Traders.” *Nasdaq*, December 22, 2020. Available at <https://www.nasdaq.com/articles/reflections-on-2020-and-whats-in-store-for-2021%3A-through-the-eyes-of-retail-traders-2020>

widespread availability of fractional-share trading,<sup>2</sup> the ability to open accounts with low balances, and the ease of app-based trading platforms. Even limited entertainment options during the pandemic probably played a role in increased retail interest in investing.

Retail participation in our equities markets is important and beneficial. Retail investors are widely understood as providing liquidity in markets. The fact that retail investors behave differently from institutional ones, and sometimes behave differently from each other—far from being a bad thing—can be particularly valuable in times of market stress. Where institutional liquidity dries up, for example, retail trading can help to lower bid-ask spreads and dampen the price impact of trades.<sup>3</sup> In fact, retail investors may have been a market-stabilizing force during the March 2020 coronavirus-induced market crash by staying the course with their investments and buying when stock prices dipped.<sup>4</sup>

Investing in the stock market also provides an important path to wealth for individual investors. With average annual returns for the S&P 500 during the past 60 years of approximately 8%,<sup>5</sup> long-term investors generally benefit by being invested in the market.

There is already a strong degree of retail participation in the U.S. stock market; when measured in 2018, approximately 38% of total U.S. equities were held directly by households.<sup>6</sup> However, only 15% of U.S. households directly hold stock.<sup>7</sup> In other words, ownership of equities is concentrated in the hands of the comparatively few and comparatively wealthy.<sup>8</sup>

Even if you include pooled investment funds, which is how the vast majority of households indirectly hold stocks as a part of their retirement assets, ownership is still skewed

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<sup>2</sup> Fractional-share trading, which permits investors to buy a portion of a stock less than one share, increased in availability throughout 2020. Julia Carpenter. “When Some Investors Look at Stocks They See Dollars, Not Shares.” *Wall Street Journal*, January 15, 2021. Available at <https://www.wsj.com/articles/when-some-investors-look-at-stocks-they-see-dollars-not-shares-11610706630?reflink=e2twmkt>

<sup>3</sup> Gideon Ozik, Ronnie Sadka, and Syiy Shen. “Flattening the Illiquidity Curve: Retail Trading During the COVID-19 Lockdown.” *SSRN*, February 10, 2021. Available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3663970](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3663970)

<sup>4</sup> Ivo Welch. “The Wisdom of the Robinhood Crowd.” *NBER Working Paper*, No. 27866. Available at [https://www.nber.org/system/files/working\\_papers/w27866/w27866.pdf](https://www.nber.org/system/files/working_papers/w27866/w27866.pdf); Gideon Ozik, Ronnie Sadka, and Syiy Shen. “Flattening the Illiquidity Curve: Retail Trading During the COVID-19 Lockdown.” *SSRN*, February 10, 2021. Available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3663970](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3663970)

<sup>5</sup> J.B. Maverick. “What is the Average Annual Return for the S&P 500?” *Investopedia*, February 19, 2020. Available at <https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp>

<sup>6</sup> SIFMA. “SIFMA Insights.” *SIFMA*, October 2019. Available at <https://www.sifma.org/wp-content/uploads/2019/10/SIFMA-Insights-Who-Owns-Stocks-in-America.pdf>. The 38% figure excludes stocks indirectly held by retail investors through mutual funds or other institutions.

<sup>7</sup> Board of Governors of the Federal Reserve System. “Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances.” *Federal Reserve Bulletin*, Vol. 106, No. 5. Available at <https://www.federalreserve.gov/publications/files/scf20.pdf>

<sup>8</sup> Board of Governors of the Federal Reserve System. “Survey of Consumer Finances (SCF).” Available at [https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly\\_Held\\_Stocks;demographic:inccat;population:1,2,3,4,5,6;units:have](https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly_Held_Stocks;demographic:inccat;population:1,2,3,4,5,6;units:have)

towards the wealthy. In 2019, about 53% of all households had stock market investments, but only 31% of families in the bottom half of the income distribution were invested.<sup>9</sup>

Stock ownership is also highly correlated with race, education, and age.<sup>10</sup> For example, in 2019, approximately 19% of white households directly held stock, compared to approximately 7% of Black households and 4% of Hispanic households.<sup>11</sup> Those with a college degree are about twice as likely to directly hold stock than those who just had some college education, and more than three times more likely than those with only a high school diploma.<sup>12</sup> And the older a person is, the more likely he or she is to own stock.<sup>13</sup> These patterns equally apply to ownership of indirectly held stock.

The retail investors making up this new surge, though, are different. Data released by brokerage firms identifies a high number of new clients who are first-time investors and who are younger than the average investor.<sup>14</sup> This is confirmed by recent research by the FINRA Investor Education Foundation and NORC at the University of Chicago (“FINRA/NORC Study”), which found that investors who opened a taxable investment account for the first time in 2020 were younger, had lower incomes, and were more racially diverse than those who had previously opened such accounts.<sup>15</sup> These new investors also held lower account balances, with about a third holding account balances less than \$500. Indeed, the ability to invest with a small amount of money was a commonly cited reason for opening an account for the first time in 2020. This may portend, as one of the researchers noted, “a shift towards more equitable investment participation.”<sup>16</sup>

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<sup>9</sup> Board of Governors of the Federal Reserve System. “Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances.” *Federal Reserve Bulletin*, Vol. 106, No. 5. Available at <https://www.federalreserve.gov/publications/files/scf20.pdf>. By comparison, about 70% of families in the 50-80th percentiles held stock, and more than 90% of families in the top decile held stock.

<sup>10</sup> Lydia Saad. “What percentage of Americans Owns Stock?” *Gallup*, September 13, 2019. Available at <https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx>

<sup>11</sup> Board of Governors of the Federal Reserve System. “Survey of Consumer Finances (SCF).” Available at [https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly\\_Held\\_Stocks;demographic:racecl4;population:1,2,3,4;units:have](https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly_Held_Stocks;demographic:racecl4;population:1,2,3,4;units:have)

<sup>12</sup> Board of Governors of the Federal Reserve System. “Survey of Consumer Finances (SCF).” Available at [https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly\\_Held\\_Stocks;demographic:edcl;population:all;units:have](https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly_Held_Stocks;demographic:edcl;population:all;units:have)

<sup>13</sup> Board of Governors of the Federal Reserve System. “Survey of Consumer Finances (SCF).” Available at [https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly\\_Held\\_Stocks;demographic:agecl;population:1,2,3,4,5,6;units:have](https://www.federalreserve.gov/econres/scf/dataviz/scf/chart/#series:Directly_Held_Stocks;demographic:agecl;population:1,2,3,4,5,6;units:have)

<sup>14</sup> “Millennials Working from Home May be Moving the Market.” *CNN*, June 12, 2020. Available at <https://www.cnn.com/2020/06/12/investing/millennials-investing-robinhood/index.html>; Robinhood. “Robinhood Raises \$280 Million in Series F Funding Led by Sequoia.” *Robinhood Blog*, May 4, 2020. Available at <https://blog.robinhood.com/news/2020/5/4/robinhood-raises-280-million-in-series-f-funding-led-by-sequoia>.

<sup>15</sup> FINRA. “Investing 2020: New Accounts and the People Who Opened Them.” *Consumer Insights: Money & Investing*, February 2021. Available at [https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them\\_1\\_0.pdf](https://www.finrafoundation.org/sites/finrafoundation/files/investing-2020-new-accounts-and-the-people-who-opened-them_1_0.pdf)

<sup>16</sup> Angelita Williams and Eric Young. “New Research: Global Pandemic Brings Surge of New and Experienced Retail Investors into the Stock Market.” *FINRA Media Center*, February 2, 2021. Available at

The FINRA/NORC Study also calls into question the popular narrative that the rise in retail participation is fueled by those seeking to engage in speculative behavior. New investors most often cited saving for retirement and learning about investing as goals. About a third of investors who opened accounts in 2020 did cite speculating as a goal, but the self-reported trading behavior of these investors is not consistent with day trading or similar strategies. While those who opened new accounts in 2020 appear to trade more frequently than existing account holders, approximately 40% of new investors reported making no trades per month and almost 90% made three or fewer trades a month.

It is also not clear that these new retail investors collectively are making poor decisions. The investing behaviors of retail investors has long been the subject of debate, but there is little consensus that new retail entrants are making systematically worse decisions. Rather, retail investors have received praise for identifying the market bottom in March 2020 and generating better performance than some hedge funds through the same volatile period.<sup>17</sup> Recent research studying investor holdings on Robinhood suggests that the narrative that retail investors were “cannon fodder” for more sophisticated investors is “incomplete to the point of being misleading.”<sup>18</sup> While Robinhood investors were overrepresented in certain odd stocks, those unconventional holdings were the exception, not the rule.<sup>19</sup>

The increased participation by retail investors in equities markets is positive news for both investors themselves and the markets. Opportunities for individuals to grow their own wealth should be welcomed and expanded, not restricted.<sup>20</sup>

## GameStop Phenomenon

At the outset, I will note that it is difficult to analyze the impact of the trading in GameStop and other stocks because many facts remain unknown at this time. While the popular narrative is that retail traders rose up to target hedge fund short positions, we do not have the data to know what portion of GameStop’s rise was attributable to retail investor

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<https://www.finra.org/media-center/newsreleases/2021/new-research-global-pandemic-brings-surge-new-and-experienced-retail>

<sup>17</sup> Maggie Fitzgerald. “Robinhood Traders Nailed the Market Bottom, Debunking Theory Retail Investors are the Dumb Money.” *CNBC*, June 15, 2020. Available at <https://www.cnbc.com/2020/06/15/robinhood-traders-nailed-the-market-bottom-debunking-myth-retail-traders-are-the-dumb-money.html>; Maggie Fitzgerald. “Follow Robinhood Traders? Amateurs’ Favorite Stocks are Beating Hedge Fund Picks, Goldman Says.” *CNBC*, June 15, 2020. Available at [https://www.cnbc.com/2020/06/15/follow-robinhood-traders-amateurs-favorite-stocks-are-beating-hedge-fund-picks-goldman-says.html?\\_source=sharebar%7Ctwitter&par=sharebar](https://www.cnbc.com/2020/06/15/follow-robinhood-traders-amateurs-favorite-stocks-are-beating-hedge-fund-picks-goldman-says.html?_source=sharebar%7Ctwitter&par=sharebar)

<sup>18</sup> Ivo Welch. “The Wisdom of the Robinhood Crowd.” *NBER Working Paper*, No. 27866. Available at [https://www.nber.org/system/files/working\\_papers/w27866/w27866.pdf](https://www.nber.org/system/files/working_papers/w27866/w27866.pdf)

<sup>19</sup> Ibid.

<sup>20</sup> Another place to expand opportunities for retail investors is by revising or eliminating the accredited investor definition, which limits investment in certain exempt offerings to those who meet a minimum wealth standard. The accredited investor definition has disproportionate impacts on minority and rural communities. Jennifer Schulp. “Let’s Not Backtrack on Loosening ‘Accredited Investor’ Rules.” *MarketWatch*, January 29, 2021. Available at <https://www.cato.org/article/lets-not-backtrack-loosening-accredited-investor-rules>

behavior versus the behavior of other market participants. More so, we may never have the data to determine the diverse motivations of all the individual investors who traded in GameStop.

But some things seem clear. Importantly, the temporary volatility in GameStop and others did not present a systemic risk to the functioning of our markets. As the Treasury Department recognized, following a meeting with officials from the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission, the Federal Reserve, and the Federal Reserve Bank of New York, the market's "core infrastructure was resilient during high volatility and heavy trading volume."<sup>21</sup>

This is not surprising. Despite the huge trading volume and rapid increase in value, the GameStop phenomenon affected a very small part of the market. GameStop's market capitalization, even at its peak, was around \$24 billion in an approximately \$50 trillion market.<sup>22</sup> And short interests, which may have been targeted by some traders, represent a small, and recently shrinking, portion of equity market value.<sup>23</sup> Even the wider market effects potentially attributable to the GameStop phenomenon, like the dip in the Dow Jones Industrial Average, were mild and short-lived.<sup>24</sup>

The fact that GameStop traded temporarily, and perhaps still trades, above fair estimates of the company's value is not, by itself, a reason for concern. Stock prices move in and out of alignment all the time, and markets are no strangers to bubbles. If a company is valued by the market differently than a review of its "fundamentals" suggests, it might indicate that the analysis is missing relevant information about a company's prospects or it might indicate that the company's stock price is due for a correction. The market's mechanisms, including the tool of short selling, generally work well to handle both of these circumstances. Stepping in to prevent trading when a stock price soars (or declines) contrary to conventional wisdom could limit legitimate information important to the market.

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<sup>21</sup> Jeanna Smialek and Deborah Solomon. "Yellen and Regulators Met Amid GameStop Frenzy to Discuss Market Volatility." *New York Times*, February 4, 2021. Available at <https://www.nytimes.com/2021/02/04/business/economy/yellen-gamestop.html>

<sup>22</sup> YCharts. "GameStop Corp (GME)." *YCharts Data*. Available at [https://ycharts.com/companies/GME/market\\_cap](https://ycharts.com/companies/GME/market_cap); Sibilis Research. "Total Market Value of U.S. Stock Market." *Sibilis Research Database*. Available at <https://sibilisresearch.com/data/us-stock-market-value/>

<sup>23</sup> Lu Wang. "GameStop Short Nightmare Shows Few Signs of Becoming a Contagion." *Bloomberg*, January 31, 2021. Available at <https://www.bloomberg.com/news/articles/2021-01-31/gamestop-short-nightmare-shows-few-signs-of-becoming-a-contagion>

<sup>24</sup> Yahoo! Finance. "Dow Jones Industrial Average (^DJI)." Available at <https://finance.yahoo.com/quote/%5EDJI?p=%5EDJI>; Anneken Tappe. "Dow Surges as Stocks Recover from GameStop Mania." *CNN*, February 2, 2021. Available at <https://www.cnn.com/2021/02/02/investing/dow-stock-market-gamestop-today/index.html>

The SEC, among a host of others, is reviewing the relevant trading and conducting a study of the events.<sup>25</sup> The SEC will probe whether any trading was the result of “abusive or manipulative trading activity that is prohibited by the federal securities laws,”<sup>26</sup> which generally require, with good reason, some sort of fraud or deception. There’s been little evidence of such misconduct to this point, but the SEC will have access to more information to evaluate the legality of the trading. The SEC also will probe whether any actions by regulated entities, like brokerages or hedge funds, took action “that may disadvantage investors or otherwise unduly inhibit their ability to trade certain securities.”<sup>27</sup> Brokerages, in particular, operate in a highly regulated environment, and many rules apply to their capital requirements and their treatment of customer orders. The SEC will have access to information to permit it to analyze whether any conflicts of interest inappropriately influenced decision-making. I believe the SEC and others likely have the tools necessary to address any harmful misconduct that may have occurred.

## Conclusion

I cannot opine on whether any regulatory changes are warranted on this incomplete record. In light of the minimal impact on the market’s function, I tend to believe that the answer will be no. But as regulators learn more about what happened here, there may be areas identified for improvement. Any proposals for change, though, must recognize the interconnectedness of the market and its participants. This is particularly important where, as here, individual investors are affected by both their own trading and the trading of the institutions that manage their retirement assets or mutual fund investments. The potential for unintended consequences must not be underestimated.

By no means, though, should the GameStop phenomenon result in changes that restrict retail investors’ access to the markets. Reintroducing undue barriers to participation that have been removed, or introducing new restrictions, has the potential to undo the benefits of wider retail participation in our equities markets.

Thank you for the opportunity to provide this information, and I welcome any questions that you may have.

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<sup>25</sup> Kate Davidson and Eliza Collins. “Regulators Say Market Infrastructure was Resilient in GameStop Frenzy.” *Wall Street Journal*, February 4, 2021. Available at <https://www.wsj.com/articles/u-s-regulators-met-to-discuss-recent-market-volatility-11612479757>

<sup>26</sup> SEC. “Statement of Acting Chair Lee and Commissioners Peirce, Roisman, and Crenshaw Regarding Recent Market Volatility.” Public Statement, January 29, 2021. Available at <https://www.sec.gov/news/public-statement/joint-statement-market-volatility-2021-01-29>

<sup>27</sup> Ibid.