The Law of r/WallStreetBets

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In late January, the market was upended when shares of video game retailer GameStop suddenly climbed from roughly $30 to $347. In the days that followed, a number of other stocks were driven to all-time highs as online chatter about investments led to a market frenzy. This client alert examines GameStop's rise and the potential legal and regulatory response.

What is Wall Street Bets and What Happened?

WallStreetBets ("WSB") refers to an online chat group on the social platform Reddit (r/wallstreetbets). At its core, WSB is simply a forum for online discussion about trading and investing.

WSB was first thrust into the spotlight after the publicly traded stock for GameStop (NASDAQ: GME) rose more than 1,000% in a matter of days. It has since come to light that in 2019, a contributor on WSB began to argue that GameStop was undervalued by the market. Online chatter about GameStock picked up over the months that followed, and by mid-January 2021, WSB members began to purchase GME stock en masse, leading to a rise in share prices. As the price climbed, other retail investors began to purchase GME as well, along with large financial institutions hoping to take advantage of the upward momentum.

As the rise drew attention, even more investors purchased GME, making it one of the world's most actively traded stocks. At the same time, various hedge funds and other financial institutions had taken the position that GameStop shares would decline by short selling GME stock months before.[1] These funds collectively faced billions of dollars in losses as the market moved against them.

Confronted with unprecedented market conditions, various online trading platforms aimed at retail investors—most notably, Robinhood—suspended purchases of GME shares, along with

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other stocks that had been discussed on WSB as potential investments. This had the effect of preventing new investors from entering the market, who cried foul.

In the wake of these events, members of Congress denounced the trading halt as contrary to free market principles, and the U.S. House Committee on Financial Services announced hearings to examine "predatory conduct"[2] by hedge funds.

Likewise, the U.S. Securities Exchange Commission (SEC) announced that it would be scrutinizing social media, while still others called for all trading to be halted to allow hedge funds to rebalance their positions. For their part, many retail investors then abandoned the trading platforms that suspended stock purchases and moved to digital asset (e.g., Bitcoin) trading, contributing to a rise in prices within that market.

Legal Implications

The events surrounding WallStreetBets has given rise to a number of legal issues, a few of which will be examined here.

Trading Platforms: Less than 24 hours after online trading platform Robinhood suspended purchases of GME (and other stocks), the company was named in a class action lawsuit filed in the U.S. District Court for the Southern District of New York.[3] The lawsuit claimed that Robinhood had breached the terms of its agreement with customers and violated various non-contractual obligations (e.g., the duty of good faith and fair dealing). Since that time, dozens of lawsuits have been filed against Robinhood as well as other financial institutions alleged to have restricted trading.

Generally speaking, online trading platforms word their customer agreements so as to retain broad discretion to suspend trading, particularly in the event that market conditions present a risk that the company will fail to meet its regulatory requirements (e.g., rules regarding the amount of liquid assets that must be available to satisfy trading obligations). Robinhood and other platforms are thus likely to argue that they were permitted (or perhaps required) to suspend purchases.

From a regulatory perspective, state and federal agencies (as well as self-regulatory organizations such as FINRA) may scrutinize—minute-by-minute—the decision to suspend trading and the resulting harm to retail investors. Given that the threat to investors has generally passed, such investigations would likely remain non-public while regulators gather and review information related to January's events. At the conclusion of such investigations—which often take months or years to complete—regulators may announce a settlement, their decision to file a complaint, or simply conclude the matter without taking action.

Hedge Funds: Much of the political fallout surrounding the WallStreetBets phenomena has been directed at hedge funds and the risks posed to the market by certain high-risk trading activities. Indeed, a number of prominent members of Congress have condemned activities by financial institutions that they claim "treat the stock market like [a] personal casino."[4] Whether this event will ultimately lead to expanded regulatory oversight, market transparency, or new rules regarding risky strategies like short selling, remains to be seen.

Notably, at least one class action has alleged that various financial institutions on the losing side of the GameStop bid conspired to stem their losses by blocking retail investor trading.[5] Such allegations, if true, would run afoul of any number of state and federal securities, antitrust, and consumer protection laws.

Conversely, hedge funds, private equity firms, and other financial institutions that *profited* from GameStop may fall under the regulatory microscope for their participation in (and presumably outsized impact on) this market event. Here too, it can be expected that litigation or investigations regarding a few extraordinary days in January may last for years.

Retail Investors: The principal legal question surrounding investors will be whether their trading amounted to market manipulation. Traditionally, market manipulation covers a wide variety of conduct that is intended to artificially inflate or deflate the price of a security.

In the same way that "boiler rooms" popularized by television and film involved individuals making phone calls to drive investor interest, the internet is now sometimes used for the same purpose. Not surprisingly, it has been reported that the SEC is reviewing message boards and social media to determine whether WallStreetBets or other retail investors intended to manipulate the market.

Whether the conduct at issues rises to the level of market manipulation is a complex and fact driven question outside the scope of this article. However, manipulation often turns on the existence of some fraud or deception. It is unclear whether the activity of WallStreetBets—much of which was discussed on public forums and involved legitimate stock purchases—would meet that standard. Intent is also critical under most constructions of market manipulation, and it is likewise unclear whether participants in WSB intended to create artificial (as opposed to actual) market demand.

A different analysis may apply, however, if new facts come to light; for example, if a WSB contributor was paid to promote GME or another stock, or GME purchases were driven by false information. In only the most egregious circumstances would the SEC (which possesses civil enforcement authority) consider referring the matter to the U.S. Department of Justice for criminal prosecution. As for the many retail investors who merely tried to take advantage of the buying frenzy around GME, it is unclear what, if any, laws would have been violated.

Conclusion

Butzel Long continues to track, analyze, and advise on a variety of issues relating to the financial industry. William Kraus is a Shareholder in Butzel Long's Ann Arbor office. George Donnini is a Shareholder in Butzel Long's Bloomfield Hills office.

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[1] Short selling generally refers to the practice of borrowing stock shares with an obligation to return them at some point in the future for a profit. As an example, a person may borrow 100 shares of stock worth $50 a share. That person will then sell those shares at the current market price, hoping that the price will decline (e.g., to $30) before they are required to return the 100 shares. Should the price decline, the person shorting buys back the 100 shares at the lower price and profits from the difference (e.g., $20). On the other hand, if the price climbs, the short seller must repurchase the shares they borrowed at the higher market price, losing money.

[2] *Following Recent Market Instability, Waters Announces Hearing on Short Selling, Online Trading Platforms*, https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=407096

[3] *Nelson v. Robinhood Financial LLC*, No. 1:21-cv-00777-JMF (S.D.N.Y.)

[4] *Senator Warren Releases Statement on GameStop Trades*, https://www.warren.senate.gov/newsroom/press-releases/senator-warren-releases-statement-on-gamestop-trades

[5] *Clapp v. Ally Financial Inc., et al.*, No. 3:21-cv-00896 (N.D. Cal.).