Twitter Thread by James Fallows Tierney

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THREAD: What are some Posting Traders doing, and what do the federal securities laws say about it? A securities law professor tries to make it simple.

(Tl;dr? Some people on the Internet will be surprised when the SEC investigates them for market manipulation.)

Backstory: what's going on? GameStop sells video games (you've maybe seen their stores in strip malls). Its business model hasn't been doing so hot.

It's a public company, so you could go on your broker's website and trade its stock. Its price had been low for a while.

One very simple way to think about stock investing is that you can make two main types of bets: that a stock's price will go up, or go down.

Some big hedge funds (think BILLIONS) were betting that it'd go down. This is called a "short" bet.

The goal of a short sale is to sell high, buy low, and pocket the difference. Suppose you pay a small rental fee to borrow a stock, sell, and hope to rebuy it later at a lower price when you've said you'll give it back to the lender.

Note for later: "borrowing" is important.

The other kind of bet is a "long" sale, in which you buy a stock for its income (dividends) or the possibility of selling it for a higher price later (capital gains).

Compared with someone "short," someone "long" a stock actually has it (kinda).

In general, short sales tend to be made by sophisticated and wealthy investors, not mom-and-pop traders.

Shorting is controversial; it puts downward pressure on stock price. Long investors, big (Elon Musk) and small (mom and pop) alike, don't want to lose from low stock prices.

Some of them post on Reddit, where there's a community of people who talk about investing. Some members made some waves early last year for making big waves in the prices of stocks through coordinated buying and selling.

https://t.co/abvqutbusN

The posters settled on a particular strategy. We talked about long and short, but there's another kind of bet.

Instead of buying or selling the stock, you can buy options—also bets on a stock price going up or down—more cheaply from a big financial institution middleman.

Those big institutions don't actually want to be on the other side of your bet, so they will hedge their risk. If you bet the stock will go up, they might buy the stock to help fund your payout if you win.

This might put upward pressure on stock price. So one strategy the Reddit posters have adopted is to buy call options (bets that the stock will go up) at higher and higher target prices.

But then it occurred to someone that pushing stock prices higher in this way might be a way to get back at (or take money from) the hedge funds that were making "short" bets.

When you make a short bet, you're selling something borrowed. So you have to put up collateral, or "margin," just like on other kinds of loans.

If the price goes up, it eats away at the collateral available to cover the bet if it goes bad. So you have to put up more collateral.

A long investor can lose up to the amount of their initial investment if asset value goes to 0.

But because stock prices are theoretically limitless, a short investor faces potentially unlimited losses from a bad bet, if the price at which they buy back the stock skyrockets.

It's more technical than I want to get into in this thread (heck yeah #RegSHO) but let's just say it gets harder, and more expensive, to keep a short sale going the more volatile the stock's price gets.

There's information out there, if you know where to look, about which companies have a lot of short sellers. GameStop was one of them.

In fact, for GameStop there are more shares sold short than there are available to be bought back. So those holding the stock can sell.

So here's the strategy with GameStop:
1. Buy options to raise stock price.
2. Higher price forces short sellers to put up more margin.
3. Shorts also have to "cover" by buying back at much higher prices.
4. You sell to them at the high price.
5. Maybe destroy hedge fund?

As @matt_levine wrote today, as a theory of how to profit from this strategy, it "is, uh, not wrong?"

Seems to have worked in the case of Melvin Capital, a hedge fund that had to "cover" its short position and get bailed out by other rich people. (Follow Matt if not already.)

This is maybe good, and maybe bad. Maybe you like the David vs. Goliath story. Maybe you think short sellers are bad. Maybe you think it exposes the hypocrisy of modern markets.

But I'm here to talk about federal securities law. (I'm not a NE lawyer and this isn't legal advice.)

https://t.co/RFsx8eGYVJ

The SEC yesterday announced it was aware of all this and is "review[ing] the activities of regulated entities, financial intermediaries, and other market participants."

That last group includes everyone I talked about above short sellers, posters, all.

You might ask how the posters could be in trouble. One way: it fits a rough pattern that securities regulators often go after for fraud, the "pump and dump" scheme. That's an easy mental model to fit the case into. But is it fraud if you're announcing it?

https://t.co/9KSUhIwXAN

> It has the whiff of a pump and dump scheme, when fraudsters drum up support for a worthless stock before selling to dummies. That is undoubtedly the mental model that ENF investigators are trying to fit it in.
>
> — James Fallows Tierney (@JamesFTierney) January 28, 2021

Securities regulators have tools beyond "fraud" at their disposal to get at other objectionable market practices. One such tool is Section 9 of the '34 Act, which prohibits manipulation. The SEC once called it "the very heart" of the act. https://t.co/B2amYvRAX7

Section 9(a)(2) makes it illegal to raise the price of a stock "for the purpose of inducing the purchase ... of such security by others."

Sound familiar? Look again above at GameStop "strategy" steps 1-4. Can posts show that "purpose"?

https://t.co/O8qIHXzJ2T

I don't mean to suggest traders have violated § 9(a)(2) (def isn't legal advice).

But the SEC is undoubtedly looking into it.

Maybe it is or isn't a winning theory. But putting it to the test is costly. The SEC typically has leverage to get its targets to settle.

As @ProfFletcher noted in a recent @DukeLawJournal article, "the SEC has not made much use of this provision." Maybe that'll change soon.

(The rest of her article, about open market manipulation, is great and worth reading!)

https://t.co/NsxRo3GuVk

There are lots of aspects to this captivating story that I haven't mentioned.

But on another level, it highlights securities law's weirdness. Our law has long taken an inconsistently skeptical view of market manipulation. Why are some practices allowed, others not?