CLIENT NOTE

GAMESTOP PHENOMENON: RETAIL VS. INVESTOR GIANTS. MARKET ABUSE OR NOT?

Overview

Within the first month of 2021, we witnessed incredible events on the stock market – interesting from both legal and market behavior perspectives. An army of retail investors, motivated by commitments reached in discussions in a Reddit forum called Wallstreetbets, rallied into massive buying of the stock of Gamestop Inc., a Texas-based video game retailer, which resulted in skyrocketing of the price of the stock and huge losses for a number of Wall Street hedge funds that had shorted the game retailer. Surging of stock prices from about $20 to $483 over a period of two weeks in January resulted in 53% loss for a New York hedge fund Melvin

Capital, which was forced to close its short position in Gamestop, followed by other major short squeezes.[1]

Responses to the described events from various players have been very diverse, including even imposition of trading halts and other restrictions. For example, brokerage platforms Robinhood, TD Ameritrade and Charles Schwab temporarily prohibited trading activities related to Gamestop stock. Meanwhile, despite the huge hype and multiple calls to SEC to mitigate the situation, the SEC issued a joint statement from its acting chair and commissioners that said it was working closely with other regulators and stock exchanges "to protect investors and to identify and pursue potential wrongdoing" and would "closely review actions ... that may disadvantage investors".[2] Some action from criminal regulators followed,[3] which, though, are yet insufficient to judge whether investors' actions will be qualified as misconduct (with relevant legal outcomes) or no.

Now, when the equity market is "back to normal",[4] we can probably try to figure out what happened on it. Did the Reddit mob manipulate and abuse the market, or the discussed situation is just a period in the smooth functioning thereof? Well, welcome to a discussion related to one the most complex and yet our favorite areas of law.

What is market abuse (manipulation)?

U. S. legislation, which is applicable to the issue being discussed in this note, contains very broad federal law provisions on prohibition of market abuse, including unathorized use of insider information, short selling, market manipulation (including price manipulation), etc. The Securities Exchange Act expressly prohibits market manipulation. This prohibition shall be applicable to any person.[5]

Among instances of price manipulation enumerated in Section 9 of the Securities Exchange Act the following can be associated with the Gamestop frenzy:

> "(2) to effect, alone or with 1 or more persons, a series of transactions in any security (…) creating actual or apparent active trading in such security (…),
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> (3) to induce the purchase and sale of any security (…) by circulation or dissemination in the ordinary course of business of information to the effect that the

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[1] See more here.
[2] *"GameStop's rocket ship has come back to earth"*. See *The Rise and Fall of the Gamestop Frenzy* by Caitlin Ostroff and Peter Santilli published on February 11, 2021 on Wall Street Journal.
[3] *"US prosecutors launch criminal probe into Gamestop mania"*. See more at https://www.aljazeera.com/economy/2021/2/12/us-prosecutors-launch-criminal-probe-into-gamestop-mania-wsj.
[4] It is worth mentioning, though, that after being down for almost a month, Gamestop stock is currently living its second best time (https://finance.yahoo.com/quote/gme/news/).
[5] The notion "any person" includes both investors (retail and institutional) and professional market participants. See Section 9 of Securities Exchange Act of 1934.

> price of any such security will or is likely to rise or fall because of market operations of any 1 or more persons conducted for the purpose of raising or depressing the price of such security,
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> (4) (…) to make, regarding any security (…), for the purpose of inducing the purchase or sale of such security (…) any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which that person knew or had reasonable ground to believe it was false or misleading."

(3) and (4) above refer to the famous pump-and-dump scheme, which is, probably, the oldest and "most classic" market manipulation scheme, implying, in common terms, "lying about stock" in order to boost the price thereof (well, we all watched *Wolf of Wall Street*). Yet, it is questionable whether this Gamestop scheme can be qualified as "pump and dump" in its traditional meaning. In particular, definition of pump-and-dump implies "pumping" by a particular investor or broker the price of stock owned or controlled by them and then selling the stock at higher price, which later – after the price is dumped – will inevitably result in huge losses to new investors. In the case at hand, we deal with simple commitment to buy Gamestop stock, which, in our firm opinion, in the light of the above-mentioned can in no circumstances fall within the meaning of "pump-and-dump". After all, what can be wrong with buying stock in order to benefit from its price going high, even if the investors know such trade will drive the prices up further and can result in short squezees for other traders? Isn't that how stock markets function?

The issue at hand has similarities mostly with instance (2) above, so the analysis whether there has or has not been price manipulation should be conducted in light of that provision. To establish existence of a market manipulation, US regulators and other relevant entities traditionally apply the four-prong test crystalized in well-established case law. The test, in particular, requires determination of the following features to establish existence of market manipulation:

> (1) that the accused had the ability to influence market prices; (2) that the accused specifically intended to create or effect a price or price trend that does not reflect legitimate forces of supply and demand; (3) that artificial prices existed; and (4) that the accused caused the artificial prices.[6]

So, if paraphrased to casual terms, buying stock with an explicit aim of pushing its price up in order to have higher income at the sale thereof is market manipulation. Furthermore, conspiring with the same aim of creating artificial prices is an aggravating circumstance of alleged price manipulation.

At the same time, buying stock that is intensively traded at a current point of time with the hope that prices will go higher certainly is not a manipulation, but a quite simple investment strategy.

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[6] See https://www.cftc.gov/sites/default/files/idc/groups/public/@lrfederalregister/documents/file/2011-17549a.pdf for thorough information on the test.

What also makes regulatory action in relation to retail investors very dificult, is the big quantity of those investors. Targeting thousands of investors will require unproportionally much resources and will definitely go beyond SEC's case law, which is mainly about "punishing big fish".

Thus, the situation is unique and complex. In particular, even though it reflects features of price manipulation, legal action in that regard will require departure from well-established case law and employment of totally new standards of assessment, which will inevitably impair market freedom in one way or another.

At the same time, let's not forget that criminal authorities have also undertaken some action with regard to the issue. Not addressing the prosecutors' action in this note, we just find it necessary to mention that criminal proceeding standards, including standard of proof and evidentiary threshold, are much higher than those of civil regulators, which, in our belief, will turn criminal responsibility of alleged price manipulators almost impossible.

Could something like Gamestop mania occur in Armenia?

Of course, stock exchange trades are not very much dependent on international borders, and Armenian investors, both retail and insitutional, could have well participated in Gamestop trades and could have had both benefits and losses. However, let's imagine Armenian retail investors have rallied into a stock on the Armenian Stock Exchange and pumped the price thereof, causing insolvency of a professional participant of securities market. Will that qualify as market abuse under Armenian law?

According to Article 171 of the Law on the Securities Market, price manipulations in the securities market shall be prohibited. Within the meaning of the Law a price manipulation shall be deemed to be:

> (1) conclusion of such transactions or making orders on conclusion thereof, which leads or may lead to shaping a wrong or misleading idea on the price of a security in the market, on the volume of demand for or supply thereof or wrongful or misleading signaling, except for the cases when the person concluding the transaction or having had made the order for conclusion of the transaction acted in compliance with the decision prescribed by Article 171(3) of this Law; (2) conclusion of such transactions or making orders on conclusion thereof that leads to irregular price deviations or to establishing an artificial level of the price of the security, except for the cases where the person concluding the transaction or having had made the order on conclusion of the transaction acted in compliance with the decision defined Article 171(3) of this Law; (3) conclusion of transactions or making orders on conclusion thereof, which is carried out with application of false mechanisms, mechanisms of bad faith or mechanisms leading to misunderstanding and/or misleading mechanisms; (4) spreading information that communicates wrong or misleading signals regarding prices of the securities to the market participants, including spreading distorted information on the given security, where the person spreading that information knew or in the case of paying reasonable attention could have known about the fact of not corresponding thereof to the

reality; (5) actions which do not constitute actions specified in points 1-4 above, but are of a similar nature.

Regulation 4/17 of the Central Bank of Armenia sets out criteria of price manipulation. The extensive non-exclusive list of actions and transactions which shall be considered as market manipulation includes entering into transactions with sole aim of changing the price of a security, creating a false or misguiding picture of demand and supply, as well as such transactions that can result in illegitimate or artificial fluctuations of price of securities.

No case law has been generated in regard these regulations, which makes predictions about courts' position towards such situation difficult. However, as can be seen from the above-described, Armenian legislative definition of price manipulation is quite broad, which means actions of retail investors aimed at taking down institutional investors similar to those of the Reddit mob can theoretically be qualified as price manipulation under Article 171 of the Law on Securities Market, just like U. S. events could theoretically be qualified as price manipulation under Section 9 of the Securities Exchange Act.

How we can help

Our team is experienced in providing sophisticated legal advice related to a wide range of complex issues associated with stock markets, including market abuse and manipulation.

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