This article is licensed by Copyright Agency and has been reproduced with the permission of the publishers via Copyright Agency Limited. You must not copy this work without permission.

Robinhood traders should not be GameStopped

Regulation

Jonathan Wenig

The widely publicised antics of two species of disruptive investors over recent months has amplified the chatter in Australian regulatory/political/legal/business media circles about whether and how to regulate activity that can smell a lot like market manipulation.

A new breed of so-called "Robinhood traders" – young, amateur retail investors, who use social media platforms like Reddit to discuss which shares to "yolo" and which to avoid – used struggling video game, electronics and gaming merchandise retailer GameStop to flex their strength in numbers.

Having discerned that an old guard of hedge funds held significant naked short selling positions on GameStop shares, an army of Robinhood traders flocked to social media to encourage like-minded investors to take a stake in GameStop, causing a short squeeze.

To break down the jargon behind the GameStop saga: an investor "short sells" a share when, expecting that its value will fall, they borrow that share and sell it on the sharemarket with the aim of buying it back at a lower price. A "naked short sell" occurs when an investor short sells a share that is not confirmed to exist.

Where institutional shareholders hold significant naked short selling positions on a certain company's shares, their value will generally fall as the market is flooded with investors seeking to sell shares that may not exist. A sharp rise in the price of that share will result in a "short squeeze", where the short selling investors are forced to buy back at a higher price to prevent further losses.

With GameStop, naked shorting hedge funds found themselves in a particularly dire situation as they were forced to try buying back shares that didn't exist. The Robinhood army established itself as a force in the market – at its peak in late January, GameStop shares had a pre-market value of more than $US500 a share, almost 30 times higher than their worth a month earlier.

Established hedge funds such as Melvin Capital took heavy losses. Eventually, when GameStop shares fell, many of the amateur investors also lost but figured the bigger victory to have been worth the hit.

While some had invested in GameStop to make a profit, many simply wanted to stick it to the establishment who, in their view, had been gatekeeping the sharemarket and freely engaging in conduct they viewed as a form of market manipulation.

Which brings us to the second evolving species of investor, whose behaviour Arnold Bloch Leibler has observed at close quarters when it has targeted our corporate clients.

In reality, it's a sub-species of short sellers who bolster their short selling with (dis)information campaigns aimed at ramping up selling activity, driving down the share price and making money for themselves.

Nine's investigative journalist Adele Ferguson exposed the practices of this new, more aggressive, style of short-selling late last year, highlighting the experience of ASX-listed agricultural investment firm Rural Funds Group, whose share price plunged 42 per cent just 30 minutes after it was targeted by a Texas-based activist short-selling operator, Bonitas Research.

ASIC has been understandably reluctant to go after this style of short seller because it's far easier for the short seller to throw mud than it is to effectively police the activity. And, as we've found with our own clients, the majority of affected companies are more interested in responding to the campaign, seeing off the shorters and getting on with business than engaging in costly and time-consuming litigation.

The two concurrent investor trends cited here – both involving (potential) misinformation, both with the stench of market manipulation and both difficult to police – represent a genuine threat to the fundamental principles that underpin corporate law as it relates to public companies in Australia.

But it would be a backwards step and a real pity if regulators responded by taking the easier road in cracking down on share trading forums without corresponding consideration being given to the nefarious activity in the more institutional space.

Disintermediation of our share market is a good thing. Just as Spotify, YouTube and TikTok have democratised music and brought artists closer to their customers, we should welcome those same trends showing up in our sharemarkets.

It is refreshing to see retail investors no longer operating simply as pawns, manipulated by the top end of town, seeing their own pockets empty as the short sellers line theirs. Robinhood traders shouldn't be GameStopped.

Rather, shareholder communication must be brought into the 21st century so that retail shareholders can meaningfully engage with the companies in which they are invested.

We need more active regulation of short sellers and/or their associates priming the market with misinformation, but not by implementing policies that make it harder for retail shareholders to participate. We've had a reality check that it's time our regulatory framework took account of a market situation that isn't in Kansas any more.

Jonathan Wenig is lead corporate and M&A partner at Arnold Bloch Leibler