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WallStreetBets: Evaluating Market Manipulation Through a Psychological and Legal Scope

Introduction

In 2021, while a global pandemic uprooted the world economy, “amateur” traders caused mayhem in the stock market, making many experienced traders turn their heads, and undermining hedge funds. WallStreetBets, an online forum, had pulled off something never seen before by sending GameStop stock from $31.40 a share to $354.83 per share in less than a month’s time. This was because WallStreetBets had caused a short squeeze which is “a phenomenon in financial markets where a sharp rise in the price of an asset forces traders who previously sold short to close out their positions” (Corporate Finance Institute 2022). That was a 1,030% change and other stocks had similar price and percentage changes like AMC and Bed, Bath, and Beyond. These were considered meme stocks because they were popularized on social media and invested in because of momentum not fundamentals. All of these meme stocks were influenced by WallStreetBets. Even people that don’t know much about stocks or investing, became interested in finding out what happened, and how they could become a part of it. Some people were amazed at how they made so much money so quickly and wanted to do the same, while the experienced traders and value investors were not happy complaining about what went on and claimed market manipulation. The WallStreetBets group took an unorthodox approach to investing causing the meme stock craze, and after comparing the investing strategies and traits to

value investors, looking at the situation with a psychological sense, using the angle of behavioral finance, and analyzing the legal aspect, a case of market manipulation against WallStreetBets exists.

Background

During the coronavirus pandemic, many people were sitting at home looking for new things to do as hobbies and new ways to socialize with others while not leaving their houses. Robinhood made it easy to start trading for beginners and on mobile devices, and Reddit was a network of communities where you can join group chats for anything you may be interested in. According to Statista, Robinhood had 10 million users in 2019, which then grew to 12.5 million in 2020, and 22.7 million in 2021 (Statista 2022). Reddit similarly saw growth throughout the pandemic with their daily active users going from 36 million in 2019 to 52 million in 2020 (Curry 2022). A Reddit group called WallStreetBets, now legendary, founded in 2012, had 3 million members on January 27th, 2021, but grew rapidly to 8 million members as of February 3rd ,2021. Essentially it was a very large stock and option trading community giving out signals on stocks they were watching or had positions in. There was no leader or person in charge, people just wrote messages into the chat with ideas and if others agreed they would follow the advice and invest their own money.

When the group came to a consensus and everyone invested into the same stock causing the share price to move up drastically, it was referred to as the “meme stock craze” or “reddit rally”. GameStop is the most well-known stock affected by WallStreetBets, so let’s take a look at the crazy ride it went on. On December 9th, 2020, GameStop missed earnings reporting a $63 million operating loss and the stock dropped 20% to $13.66 a share. On January 11, 2021, GameStop announced Ryan Cohen and 2 others to be directors on the board. Ryan Cohen was

former CEO of Chewy and is one of the largest GameStop shareholders through his private firm. This got WallStreetBets talking about GameStop and on January 13th the stock rose 50% to $31.40 a share. On January 19th Citron Research, a stock research firm, who was shorting GameStop tweeted calling GameStop buyers' "suckers" and the stock closed on January 22nd at $65.01. Citron in their tweet said the stock would "go back to $20 fast" and that anyone buying GameStop at this level were "suckers". Over the weekend during market after hours, the stock continued to climb and opened January 25th at $96.73 a share. On January 26th, Tesla CEO and billionaire Elon Musk tweeted "Gamestonk" in support of WallStreetBets causing shares to soar after hours and GameStop opened on January 27th at $354.83 a share. Then, on January 28th Robinhood and TD Ameritrade halted trading and restricted transactions on GameStop stock which caused much controversy. It caused many people to lose money or not be able to invest more for the possibility of making profits. Many traders were outraged and even lawmakers spoke out calling for legal action. This move by the trading platforms caused an extremely volatile day with an intraday range of $483.00 to $112.25 at close (Thorbecke 2021). The next day the U.S. Securities and Exchange Commission weighed in with a very general statement saying they were "closely monitoring and evaluating the extreme price volatility of certain stocks' trading prices over the past several days" (Thorbecke 2021). The SEC didn't want to raise more hype, so they were very careful not to specifically mention the stocks involved or name the Reddit group. The White House Press Secretary was even asked about the controversy and later in the week there were reports for a movie deal being produced by the Winklevoss twins, famous from the Facebook saga with Mark Zuckerberg, and announced they would have watch parties at AMC theaters (Thorbecke 2021). Later that week, February 4th Treasury Secretary Janet Yellen public addressed the meme stock craze on Good Morning America and after her comments

GameStop opened at $91.19 and closed at $53.33 per share (Thorbecke 2021). What WallStreetBets had accomplished in the market certainly made a lot of noise and was in the news for a while. Meme stocks gained popularity on social media platforms and started trending which then led to abnormally high trading volume and large price increases. For instance, GameStop's average volume was 29 million shares a day and on January 25th,2021 alone there was 175 million volume, making it the second largest total in a single day on a single stock and exceeding the peak set in October 2008 during the financial crisis. One of the days AMC was the most traded stock by volume in the entire stock market. There were numerous meme stocks that went through this including GameStop, AMC, Bed, Bath, and Beyond, Hertz, Blackberry and Naked Brand Group just to list a few. There were also other reasons as well for why these stocks were chosen which will be talked about later and will give a lot more credit to the "amateur" WallStreetBets traders.

Investing Traits and Strategies

WallStreetBets were looked upon as inexperienced traders that had no real plan or strategy to investing in the stock market. The community was known to be full of aggressive traders looking for short term profits. Although the community was described as greedy investors who wanted quick profits and had a very high-risk tolerance, there actually was some strategy behind their investing. WallStreetBets were able to identify a short squeeze opportunity with the GameStop stock. More people thought the price would go down and invested against GameStop than invested in it thinking the price would go up. This is done through options trading where you buy a call and make money if the share price goes up or a put where you make money if the stock price goes down. When you buy a put thinking the stock price will go down, it is referred to as shorting a stock. At the time, the short interest was 71.2 million shares while there were

only 69.7 million shares outstanding. Citadel Securities was one of the largest hedge funds in the world with a net trading revenue of $6.7 billion and basically made their money from electronically trading and executing orders placed on Robinhood or TD Ameritrade by selling stocks or options for more than it's willing to buy them and keeping the spread. Melvin Capital Management had one of its largest positions in shorting GameStop which was believed to go to bankrupt before the retail investors, Redditors, surged the stock price. By WallStreetBets running up GameStop's stock price, Melvin was losing a lot of money. This is because losses are infinite if you are betting the price will go down and the stock keeps going up. If that happens then fees go up for holding the puts and or the original investor that sold the options wants their stock back. That could mean in this case Melvin Capital needing to put more money up front to cover the options or even buy the stock back at a higher price which ultimately sends the stock even higher. At its worst, Melvin Capital was losing a billion dollars a day to WallStreetBets and had a monthly loss in January 2021 of about $6.8 billion or 54.5% (Chung 2022). Melvin Capital was able to receive payouts from billionaire friends' hedge funds Point 72 and Citadel in total of $2.75 billion. The strategy of WallStreetBets was to buy small cap and heavily shorted companies. The reason for small cap stocks was because they have much smaller daily average volumes and less shares outstanding. This makes it easier to control the supply of shares and having a larger percentage of the company which results in being able to move the price sharply with ease. WallStreetBets were mostly new investors with 2-3 years' experience maximum. They were greedy investors looking for unexpected things to happen with very high risk and an outcome of gigantic losses or profits.

The investing traits, styles, and strategies of value investors completely differ from the WallStreetBets group. Value investors have a long-term strategy and therefore use financial

ratios, historical charts, and technical analysis to find stocks they believe are underpriced and will grow over multiple years. Value investors risk level would be considered way lower than WallStreetBets and even risk averse. Value investing means looking for stocks in the market that the investor believes are underestimated and below their intrinsic or book value (Hayes 2022). Both are basically the company's total assets minus the company's total liabilities. The difference between intrinsic value and book value is book value is the present while intrinsic value uses assumptions to evaluate the future. If the market price is below the intrinsic value, then the stock is considered a good buy and if the market price is above it, then it is considered a good sell. Value investors are always looking for undervalued stocks which are when the market price is below the intrinsic value. Some other key ratios value investors look at are price to earnings (p/e ratio), price to book (p/b ratio), and debt to equity (d/e ratio). The p/e ratio shows if a stock is under or over valued by calculating the share price divided by earnings. Value investors use P/b ratios to identify potential investments and underpriced stocks by measuring market capitalization. The d/e ratio measures the extent that a company can pay off its debt and is calculated by dividing total debt by total shareholders' equity. Charlie Munger, vice chairman of Berkshire Hathaway, was Warren Buffett's financial partner and both Warren Buffett and Berkshire Hathaway are most famous for being very good value investors capturing great market returns. In Chapter 5 of Charlie Munger's book, *The Complete Investor,* he discusses 13 traits that make up "the right stuff" in a successful value investor. A couple traits Charlie listed was patience, long term oriented, passionate, and risk averse. Charlie Munger spoke at Berkshire Hathaway Annual Meetings and at one of them said "Patience combined with opportunity is a great thing to have. My grandfather taught me that opportunity is infrequent, and one has to be ready when it strikes." He also said that "success means being very patient but aggressive when

it's time" (Griffin 91). Value investors have to be patient when looking at data and graphs waiting for the right moment and then striking aggressively to try and make as much money as possible. Although it may seem like value investors and WallStreetBets are both aggressive, value investors are aggressive after being patient and waiting for the right moment while WallStreetBets will be aggressive at random times because of momentum or fear of missing out. As you may see, value investors like to use financial ratios and analysis when picking stocks compared to WallStreetBets who look for short squeezes and try to ride momentum.

Psychology and Behavioral Finance

A lot goes into buying and selling stocks and options other than evaluating share prices, looking at historical financial data and graphs, or looking at the amount of daily volume. The psychology of trading focuses on the emotions, mental state, and behaviors of investor's decision-making process and how it affects success or failure while trading securities. Simply put, psychology is the study of mind and behavior and now it is being used to see how and what investors feel or think when deciding to buy or sell stocks or options in this case. One area of psychology I decided to focus on was mob psychology and mentality. "Mob psychology, also called crowd psychology, is the branch of social psychology that examines the behavior of people in large gatherings. However, mob psychology is commonly equated with herd mentality, the idea that people in crowds cease to behave as individuals and become part of a single emotional organism" (Gale Encyclopedia of Psychology 2016). The first studies of this idea were completed in the 19th century by a French social psychologist named Gustave Le Bon. He found that when sizes of groups reached a critical mass, the group became a mob acting on emotion and not an individual's intellect. Group behavior typically follows meaningful patterns where peoples' behavior is influenced by social norms and group members (Gale Encyclopedia of

Psychology 2016). This can be applied to any group whether it be a real crowd on the street or a mob of people in an online community. Members of WallStreetBets experienced deindividuation which is a loss of self-awareness and could cause a person to behave in a way they normally would not if they weren't part of the group. Some members of WallStreetBets would not have invested so much money in such risky trades if they were not part of the Reddit forum. Another huge part of looking at trading psychology is understanding greed and fear. Typically, greed causes investors to take large risks which may result in large losses or smaller gains while fear causes investors to avoid risk and generate small returns if any. Greed is a strong desire for money which may cause trades to not turn out as well as hoped. Some scenarios where greed plays a factor could be making higher risk trades than usual, buying shares or calls of a company just because its share price went up steeply, or buying a security on a company having done no research on it. Specifically, an investor may be in a trade where they already have profits but believe they can make more money; however, the trade starts going the other way quickly losing profits and the investor is hoping to make it out of the trade either with little profit or may end up going from big profits to losses. The characteristics of greedy investors may sound familiar and could relate to the investing traits and strategies of WallStreetBets. WallStreetBets were called greedy investors who were looking for quick, large profits and invested in companies having done no research about them and invested in companies where share prices were rapidly increasing. Some might say WallStreetBets did some research to identify the short squeeze, but many amateur investors and members of the group just tried following their moves being greedy chasing the money. On the other hand, fear may cause traders to invest very little money due to being afraid of large losses, or maybe closing out of positions too early. Fear can cause investors to act irrationally and exit their position which is also called panic selling. A scenario where this

can play a factor is if a trader buys a position and it immediately goes down causing a loss of money. The trader then sells in fear of having larger losses and 10 minutes later the stock starts going up so if the trader was still holding the position, then they would be making profit. Fear and greed are so important to the psychology of trading that there is even a fear and greed index. The fear and greed index measures the emotions that most influence how much investors are willing to pay for stocks. For instance, if the index is leaning more to fear than stock prices might be below their intrinsic value due to the selloff. Conversely, if the index is on the greed side, then the market and stock prices might be overpriced.

Behavioral finance is a component of trading psychology which helps understand why people make those irrational choices while investing. Studying behavioral finance has identified some general psychological biases when trading. One of these biases is narrow framing which is investors tending to analyze situations in isolation and ignoring larger context such as wondering why a stock isn't going up and not seeing the major indexes like S&P 500 is down 2%. Another one is loss aversion which goes hand in hand with fear where investors either hold investments too long that have lost money because they thought the stock would go in direction they needed or selling winning investments too early. There's also confirmation bias which is interpreting new information or news as confirming an existing belief and hindsight bias which is the tendency to assume knowledge of an outcome after the outcome has been determined. Both of these psychological biases inhibit the ability to learn from past mistakes and can affect the mindset in the future. Psychology not only helps understand the emotional and behavioral aspects of trading but also ends up helping investors make decisions if they understand what other investors are thinking and why they make irrational decisions.

Market Manipulation and Insider Trading

Understanding the way investors think and how emotions affect their decision making, as well as understanding who WallStreetBets are and how they pulled off the meme stock craze, we have to understand what market manipulation is and why the value investors were saying it took place. According to the U.S Securities and Exchange Commission, “market manipulation is when someone artificially affects the supply or demand for a security” (SEC) like making a stock price have a dramatic change up or down. Market manipulation is a problem because if it occurs then it undermines the integrity of the market. If investors believe the market has been experiencing manipulation, then investors won’t think it is fair market to make money and will then not invest any money in the market. Market manipulation is hard to pull off with liquid securities so typically it will happen with small cap or penny stocks. Large cap companies have big trading volumes and many outstanding shares which makes it harder to control the supply of shares and price. As previously mentioned, the strategy of WallStreetBets and all the stocks affected by them were small cap stocks. One of the most common types of market manipulation is called “pump and dump” which is what value investors and experienced investors said WallStreetBets did. Pump and dump is when promoters or leaders purchase and control a significant portion of stock in a specific company and then start hyping up the stock on the internet to everybody trying to generate interest in the company and stock to make share prices go up. The promoter or leader may put out false press releases about the company to generate news being bad or good depending which way they want the price to move, or they pay promoters on social media to push a specific investment.

Insider trading is when someone “buys or sells a security in breach of a fiduciary duty or other relationship of trust on the basis of nonpublic information about the security” (SEC). Insider trading is the most popular market manipulation to hear about and see in the news. In

general, though, it is pretty difficult to identify someone specific in a market manipulation case and to prosecute them with enough evidence to find them guilty.

Wall StreetBets, in my opinion, was guilty of market manipulation but not of insider trading. Insider trading was definitely not a factor in this case as nobody in the online forum or involved breached their fiduciary duty or broke a relationship of trust. Also, none of the buying or selling of securities was done because of nonpublic or unreleased news about the company. However, I do believe and the case for market manipulation and more specifically the “pump and dump” scheme exists against the Reddit group for a number of reasons. Like mentioned earlier, a pump and dump scheme starts when someone has invests in a stock early and starts hyping it up to try and create an increase in the stock price. So, “a manipulator seeks to create a noticeable ‘spike’ in a stock’s price—a spike that other traders, perhaps naive traders searching for stocks with ‘momentum’ will notice…” (Korsmo 1). One of the founders had been invested in GameStop for a while since $4 a share and while there is no information on how many shares were owned, people can assume large profits were earned as the stock reached over $400 a share at one point. The internet has allowed these cases to happen more frequently and easily as thousands and millions of people can be reached almost instantly. WallStreetBets exposed this by creating group chat of 8 million members on an online platform who all colluded in buying the same stocks and running up the price. Another reason what WallStreetBets did was market manipulation is that pump and dump schemes typically target small cap stocks which was the exact strategy of the group. Small cap stocks have less volume and shares outstanding which allow for easier price and volume manipulation which WallStreetBets took advantage of. As mentioned earlier, by doing what they did and creating such a noticeable share price change, many naïve and amateur investors joined the strategy in fears of missing out. WallStreetBets

investors kept buying GameStop driving the price up making money for the people that bought before creating quick profits. Market manipulation cases of pump and dump have begun to happen more frequently with the ease and accessibility of communicating over the internet. What WallStreetBets did taking advantage of shorted small cap stocks was the most clear and public case of it in the stock market. There have been a lot more cases of pump and dumps in the cryptocurrency market that started on the internet as well, but it is a lot easier to pull off and avoid penalties there as the crypto market is pretty new and unregulated. It is imperative to learn from what WallStreetBets did in the stock market and to try and create new laws and regulations so that this doesn't happen again. The government has the capability and should try to monitor online chat rooms so that large groups aren't colluding on trying to pump and dump in financial markets. There should be regulations to prevent this from happening because it also questions the purpose of the stock market. The purpose of the market is not a racetrack which WallStreetBets made it seem like. The purpose of the stock market is not to try and achieve large, quick profits. The prices of stocks in the market should be unimpeded and reflect the collective judgement amongst buyers and sellers. Businesses use the market to offset expenses and raise capital while individuals use the market to grow their money over long term. The integrity and fairness of the market was compromised because of the scenario. When market manipulation is prevalent, investors have a lack of trust and fairness in the market which lowers investors' confidence in the market and ultimately could cause investors to pull money out and not want to invest anymore which would be very problematic.

Legal

Not only did WallStreetBets commit market manipulation but there also might be a case of market manipulation against Robinhood. Robinhood will have to defend themselves in court

against a class action lawsuit because of their decision in January 2021 during the meme stock craze to partially halt trading on GameStop and AMC. According to the Chief Judge of the United States District Court for South Florida, "Robinhood's decision to temporarily bar the purchase of surging stocks like AMC, Bed Bath & Beyond and GameStop clears the "particularized threshold" of "market manipulation" for the suit to move forward (Saul 1). Robinhood had blocked the purchases of several meme stocks on January 28th, 2021 but were allowing investors to sell their positions in AMC, Bed, Bath, and Beyond, and GameStop. By only allowing investors to sell, it caused an extremely volatile day with GameStop falling from $483 a share to $112 per share. Robinhood continues to say they will "vigorously" defend themselves in court and claim they had to halt buying activity because they had to meet the deposit requirements to the clearinghouse. Currently, it takes up to two days to clear trades and for the buyer and seller to exchange money and securities. Throughout the time it takes for clearing, a third-party clearinghouse makes the broker pay a deposit until the trade goes through. In this case, Robinhood was the broker and as the stock prices and volume climbed on the meme stocks, the deposit size climbed a tremendous amount. On January 25th, Robinhood's deposit requirement was $125 million and three days later on January 28th the deposit requirement was $1.4 billion. Ultimately, Robinhood very quickly fell into a $3 billion deficit and used the time they halted buying activity to transfer funds and pay off the debt that was very quickly accrued. Another thing that may hurt Robinhood's credibility is that they have had to pay fines and penalties to government agencies for failing to meet compliance regulations and misleading customers totaling $165 million since 2020.

Conclusion

WallStreetBets will forever be a part of history for their investing strategy and what they pulled off with the size of profits for some individuals, to the effect on the market, and the effect on hedge funds. It truly was a David and Goliath story where a bunch of amateur retail investors were able to take down a large, experienced institutional investor forcing the hedge fund to eventually close. The hedge fund had lost over 6 billion dollars because of the short squeeze on meme stocks like AMC and GameStop while some individuals in WallStreetBets reported making over 46 million dollars off trades of the meme stocks. In January 2021 alone, AMC share price rose about 840% and GameStop shares rose nearly 1,700%. In a written testimony by Robinhood CEO Vlad Tenev, he reported, "the events surrounding the GameStop had about a 1 in 3.5 million chance of happening" (Orland 1). After comparing their investing strategies and traits to value investors, looking at the situation with a psychological sense, using the angle of behavioral finance and analyzing the legal aspect; the evidence emphasizes the case for market manipulation against WallStreetBets.

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