SQUIRE PATTON BOGGS

"The Big Squeeze"

GameStop and the Battle Between Wall Street and WallStreetBets

Asia Pacific – January 2021

In the latest financial event to break through to the public conscious, you may have heard of retail investors instituting a short squeeze on US brick-and-mortar video game and electronics trader GameStop Corp. (GME). This squeeze has driven GME's share price up 1,000% within the last five trading days, from approximately US$42 on 22 January 2021 up to a high of US$469 on 28 January 2021.

What is driving this sudden surge? The modern market movers WallStreetBets (WSB), a cohort of retail traders trading through user-friendly platforms such as Robinhood and sharing trading strategies and memes through the sub-reddit r/WallStreetBets,[1] who identified a heavy short position on GME held by hedge funds such as Melvin Capital, among others. Implementing a "short-squeeze", WSB users began buying shares and calls on GME stock, posting their positions to the sub-reddit and starting a run on GME stock that sent the share price "mooning" up over 1,000%.[2] This squeeze has led short-holding hedge funds to lose a reported US$5 billion, as they were forced to cover substantial short orders multiple hundreds of dollars in excess of projected prices prior to the squeeze. The sentiment on WSB eventually transitioned from a money making opportunity to a true "Robin Hood" sentiment with users urging other shareholders to hold their shares and force the hedge funds into insolvency rather than cashing in their positions and reaping the rewards of a 1,000% return on investment.

Overnight (in Australia) on 29 January, GME's share price fell back down to approximately US$120 after a number of trading platforms blocked retail investors from buying GME stock during the unprecedented surge, but has since rallied back to over US$200. Both sides of the squeeze blame each other for market manipulation, with Wall Street hedge funds pointing the finger at the collaboration and association of WSB users, while the Reddit users propagate various theories regarding back-room deals between Wall Street and trading platforms to lock retail investors out of the market and drive down prices to limit hedge fund losses.

As outsiders in Australia, "The Big Squeeze" occurring right now is inherently engaging and we recommend keeping up to date with this phenomenon as it progresses. However, this article considers the questions, how has this happened, could this happen in Australia and would a retail short squeeze like this be against Australian law? These questions are considered below.

How Has This Happened?

The practice of "shorting" a stock occurs where a trading entity, such as a hedge fund, identifies what it perceives to be an overvalued share that will decrease in value over time. Traders can agree to effectively "borrow" a share from a current shareholder, sell that share on the market at the current trading price with a contract to re-purchase another share at a later date and return it to the lender. When shorting works, a short seller pockets the difference in the market trade they made immediately after borrowing the share compared to when repurchasing the share at a later date. However, short selling is inherently risky, with the short seller subject to effectively infinite loss exposure in the event the share price goes up instead of down.[3] In the case of GME, hedge funds shorting GME at the beginning of 2021 would have expected the stock to fall below its then relatively steady trading price of US$19. Instead, over the course of less than 20 days, GME's share price exploded to over US$400, forcing hedge funds to buy back shorted shares at a monumental loss.

However, short selling itself did not cause this short-squeeze, with short selling being a common practice across all stocks in the US. In the case of GME, it was the practice of "naked shorting", where trading entities short sell shares that they actually do not possess. This appears to have happened with GME, where the total number of short positions (i.e. shares sold on a short basis) exceeded the total actively traded market of GME shares. When this happens, it can be more difficult, or impossible, for short sellers to meet their short orders with less shares available to purchase on the market than are required to be met under the shorted arrangement, therefore driving the share price up when shareholders are not enticed to sell. WSB users identified the overexposure of short sellers and proceeded to "squeeze".

1 A sub-forum on the social media platform and self-described "front page of the internet" Reddit website

2 "Mooning" being one of various colloquial terms used by WSB users, meaning here to "go to the moon" or increase in value substantially.

3 We note that short selling is more nuanced than the description above, with interest payments usually being charged on short positions introducing further risk in addition to the risk regarding the repurchase price, but such concepts are beyond the scope of this article.

Can This Happen in Australia?

In Australia, short selling is permitted, but only in accordance with the Corporations Act 2001 (Cth) and the Corporations Regulations 2001 (Cth). ASIC's Regulatory Guide, *RG 196: Short selling*, sets out the Australian legal position on short selling. To summarise, naked short selling is illegal and shorting can only occur where it is a "covered short". A short is "covered" if the person executing a short sale has an existing securities lending arrangement to have a "presently exercisable and unconditional right to vest". A "borrower" (i.e. a short seller) will be considered to have a "presently exercisable and unconditional right to vest" a share if the lending shareholder has given a contractual, enforceable, commitment to deliver the share.[4]

Assuming that Australian law is complied with, or that any illegal naked shorts are identified and addressed by ASIC before they can impact the market of that share significantly, short selling positions should not coalesce to a point where a short squeeze can be implemented through message boards and retail traders. In contrast to GME's short position exceeding its actively traded market, the most shorted shares in Australia currently do not exceed more than 15% of total available equity.[5] Accordingly, it is unlikely that a short squeeze could be implemented in Australia and certainly not to the level currently experienced with GME. Regardless, however, noise about town is that some Australian funds are re-reviewing their portfolios on a conservative basis, potentially to avoid r/WallStreetBets' sister sub-reddit r/ASX_Bets from getting any ideas.

Would a Retail Short Squeeze Infringe Australian Law?

Wall Street is claiming that the GME share price is being manipulated by WSB users through collaborative buying activity organised through Reddit and private messaging platforms like Discord. While this article does not consider whether this is illegal under US law, would this be illegal in Australia?

Section 1041A of the Corporations Act prohibits any person from carrying on or taking part in a transaction that has, or is likely to have, the effect of "creating an artificial price for trading in financial products". It is arguable that some WSB users would be guilty of creating an artificial price for GME shares. In particular, those WSB users who have transitioned from a legitimate value identifying buy to a "hold at all costs" mentality intended to bankrupt Wall Street hedge funds and retaliate against the perceived failures of Wall Street during and following the 2008 global financial crisis may be seen to be participating in an artifice. To the contrary, WSB users would claim that Wall Street hedge funds engaged in attempting to artificially impact GME's price by shorting it beyond levels of the stock's free-float.

In any event, the question remains how could you accurately identify those share purchasers who collaborated or participated through anonymous accounts online against ordinary retail investors who merely saw a stock was rising and wanted to get in on the action?

If "The Big Squeeze" were happening in Australia, there would likely be grounds for ASIC to consider market manipulation from some WSB users. However, neither side has perfectly clean hands here. There remains more to play out in this scenario, and we will be watching intently as matters continue to develop.

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4 We note that the above is a simplified summary of the Australian legal position regarding short selling and that various exceptions and guidance may impact on whether a short sale arrangement is permissible or not. For further information, please refer to RG 196.

5 As reported by the Australian Financial Review

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