SECURITIES REGULATION AND CLASS WARFARE

Jonathan R. Macey*

This Article examines the regulatory goals of creating "fair, orderly, and efficient" securities markets in light of the recent issues involving trading in the shares of GameStop Corp. (GME) through the broker-dealer firm Robinhood Financial LLC. The GameStop/Robinhood saga casts significant doubt on the notion that the SEC is achieving its goal of maintaining fair, orderly, and efficient markets, and facilitating capital formation. Moreover, the saga provides further support for the view that market forces tend to make securities markets fairer, where fairness is defined as investors "getting what they pay for," rather than as investors "beating the market" by earning abnormal returns. Further, market processes tend to make markets more efficient, while regulation tends to make markets less efficient. Finally, it appears that regulation tends to further the interests of Wall Street elites over the interests of ordinary investors.

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I. INTRODUCTION

In early 2019, an editorial in *USA Today* proclaimed that in order "[t]o understand events around the world today, one

must think in terms of the class struggle."[1] The proclamation rings true for many aspects of society, but particularly so for the law. This Article is premised on the conviction that one must think in terms of the class struggle to understand securities regulation in general. I argue that viewing securities regulation from the perspective of an economic class struggle between ordinary Main Street investors and Wall Street elites is useful for understanding the role that the Securities and Exchange Commission (SEC) continues to play in exacerbating the class conflict that inevitably has accompanied the growing income and wealth disparities in the United States.[2]

Put simply, the SEC promulgates and enforces securities regulations that benefit elites such as investment bankers, hedge fund managers, and powerful Wall Street law firms far more than they benefit ordinary investors. And this fact is well understood by non-elite market participants. Of course, that is not the way that the SEC wants to be perceived. Instead, the SEC and its Wall Street constituencies attempt to

* Sam Harris Professor of Corporate Law, Corporate Finance and Securities Law, Yale Law School. Kamini Persaud, Yale Law School Class of 2022, provided valuable research assistance.

1 Glenn Harlan Reynolds, *Donald Trump Is a Symptom of a New Kind of Class Warfare Raging at Home and Abroad*, USA TODAY, https://www.usatoday.com/story/opinion/2019/01/15/glenn-reynolds-class-warfare-elites-explains-world-conflicts-trump-column/2569252002 [https://perma.cc/3LXX-8Y28] (last updated Jan. 15, 2019, 8:52 AM).

2 In the United States, the income Gini ratio and the share of total net worth held by the top one percent have grown steadily for decades, while the share of total net worth held by the bottom fifty percent steadily declined until about 2010 (and since has grown only to about two percent). *See Income Gini Ratio for Households by Race of Householder, All Races*, FED. RSRV. BANK OF ST. LOUIS (on file with the Columbia Business Law Review), https://fred.stlouisfed.org/series/GINIALLRH (last updated May 19, 2021) (Gini ratio); *Share of Total Net Worth Held by the Top 1% (99th to 100th Wealth Percentiles)*, FED. RSRV. BANK OF ST. LOUIS (on file with the Columbia Business Law Review), https://fred.stlouisfed.org/series/WFRBST01134 (last updated May 20, 2021) (top one percent); *Share of Total Net Worth Held by the Bottom 50% (1st to 50th Wealth Percentiles)*, FED. RSRV. BANK OF ST. LOUIS (on file with the Columbia Business Law Review), https://fred.stlouisfed.org/series/WFRBSB50215 (last updated May 20, 2021) (bottom fifty percent).

depict the agency as tirelessly working to make the capital markets fair, orderly, and efficient.[3]

Regulation has not made securities markets fairer. Rather, market processes that result in accurate securities prices make markets fair by enabling buyers and sellers of securities to transact at prices that reflect the most accurate, risk-adjusted present value of the future income associated with those securities.

Unfortunately, the process of arriving at accurate prices is costly and often appears unfair. This apparent unfairness results from the fact that the process by which securities prices become more accurate systematically transfers wealth from investors who lack information to more sophisticated, professional traders who enjoy informational and institutional advantages in obtaining information and in translating that information into a profitable trading strategy.

Markets are also, by nature, not orderly; they are chaotic and unpredictable. In fact, stock prices follow a very disorderly "random walk."[4] The "random walk" means that future price movements are random and impossible to predict on the basis of historical patterns.[5] The reason that securities prices

[3] *See, e.g.*, Caroline Bradley, *Disorderly Conduct: Day Traders and the Ideology of "Fair and Orderly Markets"*, 26 J. CORP. L. 63, 64 (2000) (observing that "[p]oliticians and regulators use th[e] rhetoric [of fair and orderly markets] to justify and legitimate their actions . . . . For over sixty years, United States securities regulators have told us that if they can ensure that the markets operate in a fair and orderly manner, investors will have the confidence to invest in securities issued by businesses which need to raise capital."); *Securities Exchange Commission (SEC)*, J. REG. & COMPLIANCE, https://thejournalofregulation.com/en/article/security-exchange-commission-sec [https://perma.cc/R8L8-724C] (last visited Mar. 8, 2021); *The Role of the SEC*, U.S. SEC. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/role-sec [https://perma.cc/D44S-ZNPX] (last visited Mar. 8, 2021).

[4] Burton Malkiel popularized the fact that past movements or trends in the price of a company's shares, or in capital markets, generally cannot be used to predict future price movements. As so observed, stock prices inherently follow a random and unpredictable path that makes it impossible to predict future stock prices. BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 141–45 (7th ed. 1999) (1973).

[5] *Id.* at 142–45.

follow a random pattern is that prices react quickly to reflect new information. Rivalrous competition results in efficient markets. Regulation designed to make markets more fair leads to less efficiency. And, since efficient markets are fair markets, regulation often renders markets less fair rather than more fair.

Interestingly, a vast gulf exists between the way that securities law and securities markets are perceived by the elites and non-elites. This rift was brought into sharp focus on January 28, 2021. On that day, an elite law firm—Wachtell, Lipton, Rosen & Katz—published a paean to former SEC Chair Jay Clayton, who had concluded his term at the Commission in December 2020.[6] Wachtell's homage lauded the Clayton SEC for protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.[7] Chairman Clayton was particularly lauded for "'looking out for' the long-term interests of the [fifty-two percent] of American households who participate in the capital markets."[8] The Wachtell authors even predicted that, at some undisclosed moment in the future, "Main Street investors will reap the benefits of not only the heightened protections, but also the expanded market opportunities, that will result from SEC initiatives taken under Chairman Clayton's leadership."[9]

Wachtell emphasized the "adoption of amendments to the proxy rules regarding the role of proxy advisory firms" as an SEC initiative that would be particularly helpful to ordinary Main Street investors.[10] However, the SEC's regulation of proxy advisory firms[11] does not help Main Street investors.

[6] *See generally* DAVID A. KATZ & LAURA A. MCINTOSH, CORPORATE GOVERNANCE UPDATE: THANK YOU, CHAIRMAN CLAYTON (2021), https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.27333.21.pdf [https://perma.cc/MPV4-VYMD].

[7] *See id.* at 2–3.

[8] *Id.* at 2.

[9] *Id.*

[10] *Id.* at 2–3.

[11] For the new rules, which impose more onerous disclosure obligations on proxy advisers, see generally Exemptions from the Proxy Rules for Proxy Voting Advice, 85 Fed. Reg. 55,082 (Sept. 3, 2020) (to be codified at 17 C.F.R. pt. 240).

Instead, it creates obstacles for investors who want to challenge Wachtell's client base—entrenched management in large, publicly traded companies seeking to fend off activist investors in general and hostile takeovers in particular.

The SEC was also lauded for its promulgation of Regulation Best Interest, which establishes an enhanced standard of conduct for broker-dealers.[12] Yet in fact, Regulation Best Interest provides only tepid protection to Main Street clients of broker-dealer firms when compared with the elaborate protections provided to the more well-heeled clients of investment advisers. Contrary to Wachtell's assertion, Regulation Best Interest does not create an entitlement "to unconflicted counsel from both broker-dealers and investment advisers."[13] Although it is true that Regulation Best Interest requires enhanced disclosure of these conflicts, it does not limit conflicts of interest.[14]

Wachtell's positive sentiments regarding the state of U.S. capital market regulation stand in sharp and vivid contrast to those expressed on the social media platform Reddit's popular forum *r/wallstreetbets* (wallstreetbets).[15] To wallstreetbets, whose description reads, "like 4Chan found a Bloomberg Terminal,"[16] the SEC and its Wall Street clientele are the enemy. One particularly articulate Reddit post described the recent situation facing investors who shorted GameStop Corporation (GME) stock, stating "the government, hedge funds, brokers, et. al. still practice their dirty tricks to protect their own. We should fear the systematic risk of cronyism within the halls of

12 KATZ & MCINTOSH, *supra* note 6, at 3.

13 *Id.*

14 *See* 17 C.F.R. § 240.15*l*-1(a)(2)(iii) (2020).

15 For a general overview of the investing forum, see *wallstreetbets*, REDDIT, https://www.reddit.com/r/wallstreetbets [https://perma.cc/2F66-YMM6] (last visited Mar. 8, 2021).

16 Michelle Celarier, *Buried in Reddit, the Seeds of Melvin Capital's Crisis*, INSTITUTIONAL INV. (Jan. 25, 2021) (internal quotation marks omitted), https://www.institutionalinvestor.com/article/b1q8swwwtgr7nt/Buried-in-Reddit-the-Seeds-of-Melvin-Capital-s-Crisis [https://perma.cc/AJ2T-WSUL].

government and Wall Street to put the brakes on our profit making, which is our lawful American right."[17]

In addition to its somewhat discordant tone, the publication of Wachtell's SEC tribute was almost certainly poorly timed. It arrived in the midst of the GameStop/Reddit/Robinhood embroglio, which has been recognized as one of the biggest contretemps on Wall Street since the 2011 Occupy Wall Street protest movement. Similar to the recent GameStop scandal, Occupy Wall Street has been described by popular websites as a protest against "social and economic inequality, greed, corruption and the undue influence of corporations on government—particularly from the financial services sector."[18] Wachtell's tribute to the supposed truth, justice, and fairness of U.S. capital market regulation therefore arrived just as another round of class warfare was erupting between ordinary investors and the Wall Street hedge funds. To understand the heart of this warfare, we must delve deeper into the strategy that involved short selling shares in a variety of companies, particularly the video game retailer GameStop.[19]

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[17] u/nysrpatakemyenergy2, *If We All Come up with a Dollar or Two, We Could Get the Best Securities Lawyers on Retainer for a Class Action if the SEC Pulls Shenanigans*, REDDIT (Jan. 27, 2021, 5:05 PM), https://www.reddit.com/r/wallstreetbets/comments/l6l5i5/if_we_all_come_up_with_a_dollar_or_two_we_could [https://perma.cc/WW26-BZDY].

[18] *See, e.g.*, *Occupy Wall Street*, WIKIPEDIA, https://en.wikipedia.org/wiki/Occupy_Wall_Street [https://perma.cc/QUH6-GN77] (last modified Mar. 4, 2021). For a similar description of the GameStop traders' aims, see, for example, John Authers, *GameStop Is Rage Against the Financial Machine*, BLOOMBERG: OP. (Jan. 27, 2021, 12:31 AM), bloomberg.com/opinion/articles/2021-01-27/gamestop-short-squeeze-is-rage-against-the-financial-machine?sref=e2TM0yf8 [https://perma.cc/F8WF-TEXM].

[19] *See* Andrew Ross Sorkin et al., *How Does This End?*, N.Y. TIMES (on file with the Columbia Business Law Review), https://www.nytimes.com/2021/01/28/business/dealbook/reddit-GameStop-trading.html (last updated Jan. 29, 2021). As a general note, GameStop is a company that sells videogames and accessories, often in brick and mortar stores located in malls. *See* Sarah E. Needleman, *GameStop's New Billionaire Investor Pushes for Digital Sales, Fewer Stores*, WALL ST. J. (Nov. 16, 2020, 11:13 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/gamestops-new-billionaire-investor-calls-for-tech-centric-makeover-11605565458.

It began with a very small group of individual stock traders like Keith Gill, a Massachusetts day trader and former marketing agent for Massachusetts Mutual Life Insurance Co.[20] These individual stock traders directed the attention of a very large cadre of very small stakes amateur investors to GameStop. Mr. Gill began investing in GameStop in June 2019, when the price of the stock was around $5 per share.[21] At that time, the company was continuing to struggle against major online competitors and was not necessarily a popular name among investors.[22] Despite the lack of attention on GameStop in 2019, Mr. Gill touted the merits of the stock on YouTube and, more significantly, on Reddit's wallstreetbets forum, where he was well known by his username, "DeepF—ingValue."[23] Mr. Gill was not alone in sharing his investment advice, and misfortunes, on Reddit. Many people use Reddit and other social media platforms to "lash out against Wall Street power players, and . . . express a desire to see the financial pros reel from losses."[24] Expressing this desire, and realizing it, are two very different actions. The collaboratory spirit of Main Street investors on Reddit, brought together through GameStop stock, provided an almost perfect weapon beyond words for Reddit users to realize this desire. They sought to battle against powerful Wall Street hedge funds, lashing out by targeting the funds' bets against GameStop.[25]

On the other side of the GameStop wager, and battle, were Wall Street hedge funds such as Melvin Capital Management

[20] Julia-Ambra Verlaine & Gunjan Banerji, *Keith Gill Drove the GameStop Reddit Mania. He Talked to the Journal.*, WALL ST. J. (Jan. 29, 2021, 9:48 AM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/keith-gill-drove-the-GameStop-reddit-mania-he-talked-to-the-journal-11611931696.

[21] *Id.*

[22] Abha Bhattarai & Taylor Telford, *Despite Record Stock Surge, GameStop Is Still Struggling To Stay Afloat*, WASH. POST (Feb. 1, 2021, 4:03 PM), https://www.washingtonpost.com/business/2021/02/01/gamestop-retail-stores/ [https://perma.cc/B32D-BLAD].

[23] Verlaine & Banerji, *supra* note 20 (internal quotation marks omitted).

[24] *Id.*

[25] *See id.*

and Citron Research that engage in short selling.[26] These firms specialize in locating what they view as overvalued companies, and profiting by short selling their stock. When it became known that these hedge funds had significant short positions in GameStop, retail investors on wallstreetbets began broadcasting their intentions to "take down" the hedge funds.[27] To do so, the investors began to buy GameStop shares, as well as call options on GameStop, to drive the company's share price higher.[28] By driving the company's share price higher, the investors would be indirectly driving down the value of the short positions of Melvin Capital, Citron, and others betting that the stock would go lower.

Through their collective actions, teeming hordes of Reddit traders decided to turn the tables on the wealthy short sellers—and they were astonishingly successful. Purchases of stock and call options in GameStop raised the company's share price by more than 1,500% during the month of January 2021.[29] By the morning of January 29, 2021, short sellers had recorded estimated losses of more than $19 billion from their trading positions in GameStop.[30] One news source described the phenomenon as follows:

> Fueled by the army of day traders that populates Reddit's "Wall Street Bets" forum, GameStop saw its market capitalization go from $3 billion to $25 billion in a week. In a kind of stock-market flash mob, retail

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[26] *See* Ben Winck, *GameStop Short-Sellers Melvin Capital and Citron Surrender Bearish Bets After 700% Rally Drives Huge Losses*, BUS. INSIDER: MKTS. INSIDER (Jan. 27, 2021, 9:42 AM), https://markets.businessinsider.com/news/stocks/gamestop-stock-short-sellers-melvin-capital-citron-surrender-bets-gme-2021-1-1030010382 [https://perma.cc/28NM-LTZN].

[27] *See* Celarier, *supra* note 16 (discussing Melvin Capital).

[28] *Id.*

[29] Harry Robertson, *Short-Sellers Are Nursing Estimated Losses of $19 Billion in 2021 After Betting on GameStop's Stock To Plunge*, BUS. INSIDER: MKTS. INSIDER (Jan. 30, 2021, 2:31 PM), https://markets.businessinsider.com/news/stocks/short-sellers-sitting-on-19-billion-of-losses-on-GameStop-data-shows-2021-1-1030020684 [https://perma.cc/BGM9-UAPA].

[30] *Id.*

> investors put enough money into risky call options to push up share prices and force short sellers out of their positions.[31]

The controversy escalated considerably on January 28, 2021, when certain brokerage firms responded by limiting, or shutting down, the trading of stocks and/or options.[32] In particular, Robinhood and Interactive Brokers, the retail brokerage platforms preferred by Reddit fans and where most of the buying frenzy was centered, halted trading in GameStop.[33] The move was characterized as an effort to protect institutional investors at the expense of ordinary investors.[34] It was perceived, and rightly so, as highly unfair.[35] As a practical matter, the move resulted in a situation in which small retail traders were locked out of the market while professional Wall Street investors were given free rein to cover their shorts.[36] The Wall Street elite were made free of the upward pressure on the stock that would have otherwise been exerted by small investors trading on Robinhood.

At a minimum, the Reddit/GameStop saga casts significant doubt on the notion that the SEC is achieving its "tripartite purpose . . . to maintain fair, orderly, and efficient markets, and to facilitate capital formation."[37] The saga was nothing short of a class conflict in which the investing proletariat sought out, did battle with, and achieved at least a fleeting victory over its avowed enemies—the Wall Street elites and the SEC—by driving the price of GameStop to levels far beyond what any rational market analyst would consider sane.

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[31] Daniel Tenreiro, *Why Robinhood Halted GameStop Trading*, YAHOO!: NEWS (Jan. 28, 2021), https://news.yahoo.com/why-robinhood-halted-GameStop-trading-011448173.html [https://perma.cc/9TJV-UWE7].

[32] *Id.*

[33] *Id.*

[34] *See id.*

[35] *See* James Politi, *'Let them Trade': Washington Struggles with Robinhood Politics*, FIN. TIMES (Feb. 3, 2021) (on file with the Columbia Business Law Review), https://www.ft.com/content/a0ff1262-9f61-4a23-a057-2884cfdec6b7.

[36] *See id.*

[37] *See* KATZ & MCINTOSH, *supra* note 6, at 2.

If this saga shows anything, it is that outside of the corridors of the SEC, elite law firms, and the nation's largest financial institutions, the financial markets are not perceived as fair, or orderly, or efficient—for good reason. Wachtell's memo, viewed in light of the Reddit/GameStop saga, seems questionable at minimum when one stands in the shoes of retail, Main Street investors.

This recent saga, fresh in the minds of the investing community and general public alike, brings us back to this Article's premise: that securities regulation cannot be viewed as separate from existing class conflicts and growing income and wealth disparities. In Part II of this Article, I show that the Reddit/GameStop saga demonstrates that regulation has not led to securities markets being perceived as fair, orderly, or efficient by Main Street investors, which is the group that the SEC ostensibly is supposed to serve. This Part delves further into the rift between the treatment of Wall Street traders and that of Main Street traders by securities regulators.

In Part III, I then advance the argument that the very structure of securities regulation systematically favors elite Wall Street institutional interests over the interests of Main Street investors. This favoritism is structural and unavoidable. At best, securities regulation protects investors by excluding them from the market—paternalism at its finest. At worst, the SEC and its clientele are rigging the game so that entrenched interests profit at the expense of the little guy.

II. FAIR, ORDERLY, AND EFFICIENT

The concept of market fairness must be defined with some specificity in order to explain why ordinary traders trading in efficient markets do not believe that the markets are fair. In my view, the best definition of a fair securities market is a securities market in which investors get what they pay. According to this definition, U.S. capital markets are generally fair because they are generally efficient. On the other hand, I believe that the SEC embraces a different definition of market fairness. According to the SEC's rival definition, a market is fair if and only if all investors have an equal chance of earning *abnormal returns*, where abnormal returns are defined as

returns above the risk-adjusted returns that one would receive on a diversified portfolio of securities.[38] As explained here, fairness simply is unattainable under this second definition of the term.

When market fairness is defined as giving all investors an equal chance to earn abnormal returns, it is easy to show that markets are inherently unfair because earning abnormal returns requires access to information that is not already reflected in a company's share price. And, by its very nature, this information is available to corporate insiders and professional traders before it is available to the general public.

Thus, access to information determines success in the market, and access to information is limited to insiders and those with certain levels of wealth and connections. Those with superior inherent and structural access to information invariably will profit at the expense of those with less access. Unsurprisingly, those who lack an informational edge will feel that markets are unfair.

Markets are also well known for being disorderly. Markets are driven by the release of information generated by the occurrence of real-world events, as well as by research and analysis of the implication of various phenomena for asset prices. Disorder naturally emerges through this process because it is not possible to predict when new information will emerge that disrupts existing expectations about asset prices and causes volatility. Being volatility-driven thus breeds market disorder.

Furthermore, markets can be highly inefficient at times, contrary to the general perception that markets are made naturally efficient through competition. Markets are inefficient for the same reason that they are unfair and disorderly: they are driven by human beings. As Charles P. Kindleberger observed decades ago, rational equity traders know that they

[38] In a recent example of an effort by the SEC to "protect" investors from themselves, the SEC effectively forbade Hertz Corporation from selling stock to the public. *See* Anthony J. Casey & Joshua C. Macey, *The Hertz Maneuver (And the Limits of Bankruptcy)*, U. CHI. L. REV. ONLINE, Oct. 7, 2020, at 1, 2–3, 16–17 (questioning the legitimacy of the SEC's intervention on the basis of investor irrationality).

can make money in the long run by predicting how a company will perform, but they can also make money in the short run by predicting what other, sometimes irrational, and often highly emotional, traders will do.[39] It is rational for a trader to buy a stock that he knows is overvalued, even massively overvalued, if he is confident that another buyer will emerge who is willing to pay an even higher price. The eternal problem, as John Maynard Keynes observed and as a number of U.S. hedge funds recently learned, is that "[m]arkets can stay irrational longer than you can stay solvent."[40]

The SEC does not have the ability to make markets fair, orderly, or efficient. However, it does have the ability, and the obligation, to help move markets towards greater fairness, order, and efficiency. It is on this count that the SEC has failed.

A. Fairness

The fundamental unfairness of the capital markets has been manifested through the explicit tilt of capital markets regulation for the benefit of Wall Street elites. It emanates from the fact that securities regulation benefits securities market professionals. One of these benefits involves the elimination of competition in trading from both (1) those who have informational advantages over Wall Street professionals and (2) those who are at an informational disadvantage relative to such traders.

Trading profits accrue to those who are able to obtain material information about a company that is not already reflected in share prices (nonpublic information) and then trade on that information before the market reacts. For example, consider an informed market participant. This market

[39] *See* ROBERT Z. ALIBER & CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES 61–63 (Palgrave Macmillan 7th ed. 2015) (1978).

[40] Maureen O'Hara, *The GameStop Chaos May Be a 'Bubble,' but What Does that Actually Mean?*, WASH. POST (Jan. 29, 2021, 8:00 AM) (internal quotation marks omitted), https://www.washingtonpost.com/opinions/2021/01/29/gamestop-chaos-may-be-bubble-what-does-that-actually-mean/ [https://perma.cc/V8P4-V927] (noting that the quote is "often attributed to Keynes").

participant has information that a company is about to be the subject of a takeover bid at a substantial premium. The participant obviously can benefit from this knowledge by buying shares in the target company before the takeover is announced. Insiders who have access, by virtue of their employment, "to new firm-specific information about the present value of a firm's future cash flows" inevitably will, in the absence of rules prohibiting them from trading or tipping others, "take the bulk of the gains in nearly every trading race" to obtain inside information and effectuate a trading strategy based on that information.[41]

Insider trading laws bar actual insiders from trading. But they do nothing to prevent similar trading techniques by Wall Street trading professionals. These professionals are the next-fastest informed group, "devot[ing] their careers to acquiring information about a firm . . . [or] an industry . . . and . . . developing skills for evaluating the information they obtain."[42] With their vast informational advantage and expertise, Wall Street trading elites can trade on the basis of their knowledge without legal repercussions.[43] The law favors this group because

> [u]nder present law, market professionals, unlike insiders, owe no fiduciary duty to the firms they study; their field of employment carries with it no implied responsibility to look after the firms' interests. Moreover, because he actually works in the exchanges or in closely allied firms, a market professional can execute the trade of a firm's stock more promptly than even a firm's insiders, and he can be beaten by an insider only when the latter's acquisition of information is quicker.[44]

Given the inequitable informational and legal barriers between Main Street investors and their Wall Street

[41] *See* David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311, 317–18 (1987).

[42] *Id*. at 318.

[43] *Id*.

[44] *Id*.

counterparts, the rules against insider trading do not benefit "the public" or make markets fairer. In fact, those "least likely to profit from valuable new information are ordinary shareholders and other complete 'informational outsiders.' Ordinary shareholders are at a hopeless disadvantage when they compete for trading profits against either insiders or market professionals because the outsiders cannot observe, grasp, or act on new information as promptly."[45] The point here is not that insider trading should be permitted. Rather, insider trading should be prohibited because it is inefficient and undermines companies' property rights in information.[46] But current insider trading law does not make markets fairer.

The Reddit/GameStop/Robinhood episode clearly demonstrates the Wall Street/Main Street divide. Securities law not only protects Wall Street market professionals from competition from insiders; it also protects them from competition from ordinary retail investors. These ordinary investors risk being charged with illegal share price manipulation when they attempt to galvanize themselves into an effective trading coalition to take on the Wall Street professionals. The Wall Street professionals, however, face no consequences for encouraging and engaging in such herd behavior.

Interestingly, while Wall Street elites pretend that trading markets are fair, it appears that the ordinary traders on Main Street understand that the capital markets are anything but fair.[47] The contrast between how Reddit investor-users and Wall Street elites view the regulatory landscape is stark and worthy of close attention by any student of capital markets. Of particular interest is the fact that the GameStop short sellers expect retribution from the SEC:

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[45] *Id.*

[46] *See, e.g.*, Jonathan R. Macey, *Beyond the Personal Benefit Test: The Economics of Tipping by Insiders*, 2 U. PA. J.L. & PUB. AFFS. 25, 34 (2017) (discussing some efficiency issues raised by insider trading); Jonathan Macey, Martoma *and* Newman*: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869, 873 (2018) (discussing property rights and insider trading).

[47] *See supra* Part I.

> If we all come up with a dollar or two, we could get the best securities lawyers on retainer for a class action if the SEC pulls shenanigans[.]
>
> . . . .
>
> Should the SEC illegally or unjustly intervene on behalf of their friends (who so often reward government poodle regulators with lucrative jobs after leaving civil service), we will need to find a large law firm that specializes in securities and class actions and is willing to setup a trust account where you give your name, nominal retainer fee, and proof that you owned $GME to establish standing in a suit.[48]

And there is justifiable cause for alarm. While institutional short sellers like Citron have long publicized their trading plans and their investment theories, Main Street investors who have done the same thing, even on a vastly smaller scale, have found themselves in the SEC's crosshairs. This time, the securities regulators appear to be readying to pursue those posting on Reddit.[49]

When analyzing the GameStop saga, we must understand that investors, particularly hedge funds, have often strategically used herd behavior to affect equity pricing. Famed short seller Andrew Left of Citron Research pioneered the practice of publicizing his "research" and his strategies in research reports, known as "short reports."[50] Mr. Left's research reports "encouraged others to follow his lead" with Mr. Left's company "profiting when they d[id]."[51]

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48 *See* u/nysrpatakemyenergy2, *supra* note 17.

49 *See infra* Section II.A.1.

50 *See* Matthew Fox, *Citron Research Says It Will Stop Publishing Short-Seller Research After the GameStop Squeeze*, BUS. INSIDER: MKTS. INSIDER (Jan. 29, 2021, 4:24 PM), https://markets.businessinsider.com/news/stocks/citron-stop-publishing-short-seller-research-GameStop-squeeze-andrew-left-2021-1-1030020509 [https://perma.cc/GHV2-6W9N].

51 Thomson Reuters, *Citron To Stop Publishing Short-Selling Research, Andrew Left Says*, FIN. POST (Jan. 29, 2021), https://financialpost.com/investing/citron-research-andrew-left-stop-short-selling-research-publishing [https://perma.cc/GH9J-N5ZL].

The strategy involves not only the publication of reports, but also features hedge funds proselytizing their bearish views through livestream internet broadcasts. For example, in broadcasts Mr. Left described investors in GameStop as "suckers," provided reasons why GameStop stock would fall in value, and admonished short sellers that "[w]e understand short interest better than you and will explain."[52]

Citron also engages in a practice of encouraging regulators to launch investigations into companies it is betting against.[53] The announcements of such investigations predictably lead to significant share price declines for the investigated companies[54]—allowing Citron to improve its short positions. Citron Research has been accused of "publishing deliberate yet legal falsehoods made to pass as facts in order manipulate stock prices for [its] own gains."[55] Citron's reports are usually

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[52] Shalini Nagarajan, *Short-Seller Citron Said Its Scheduled Livestream on Why GameStop Buyers Are 'Suckers at This Poker Game' Was Halted by Attempted Twitter Hacks*, BUS. INSIDER: MKTS. INSIDER (Jan. 22, 2021, 10:36 AM) (internal quotation marks omitted), https://markets.businessinsider.com/news/stocks/citron-research-livestream-GameStop-position-halted-twitter-hack-attempts-2021-1-1029993391 [https://perma.cc/9PUF-3BJ2].

[53] *See, e.g.*, CITRON RSCH., CITRON PRESENTS TO US REGULATORS DEFINITIVE EVIDENCE OF GSX TECHEDU (NYSE: GSX) COMMITTING SECURITIES FRAUD THROUGH THE USE OF MULTIPLE UNDISCLOSED RELATED PARTY TRANSACTIONS TO HIDE EXPENSES/LIABILITIES 20 (2020), https://citronresearch.com/wp-content/uploads/2020/05/Citron-presents-to-US-regulators-definitive-evidence-of-GSX-Techedu-update.pdf [https://perma.cc/222K-97L6].

[54] For example, reports by Citron and others led to the SEC investigation of GSX Techedu and, eventually, a significant drop in its stock price that cost its founder $3.1 billion in a single day. Emily Graffeo, *David Einhorn Slammed the SEC for Not Noticing the 'Real Story' of Archegos, Which He Says Involves the Firm Driving a 400% Gain in a Company Short-Sellers Call a Fraud*, BUS. INSIDER: MKTS. INSIDER (Apr. 17, 2021, 7:39 AM), https://markets.businessinsider.com/news/stocks/david-einhorn-investor-letter-archegos-gsxtechedu-stock-trading-real-story-2021-4-1030314247#:~:text=In%20a%20recent%20investor%20letter,most%20of%20its%20available%20shares [https://perma.cc/6GYS-WTG9].

[55] Mo Samara, *Appeal to FINRA and SEC Enforcements To Investigate Andrew Left of Citron Research*, CHANGE.ORG, https://www.change.org/p/u-

damning in tone, armed with a provocative headline, and followed up with a targeted social-media push.[56] It conducts this price manipulation with expertise, spinning existing facts into a horrible scenario that reads very badly, in order to create market panic.[57]

1. Manipulation on Main Street

Securities regulation is different on Main Street than it is on Wall Street. There is no better example of this disparity than the 2000 SEC enforcement action for securities fraud against fifteen-year-old high-school student Jonathan Lebed.[58] The SEC accused Mr. Lebed of "us[ing] the Internet to promote stocks from his bedroom in the northern New Jersey suburb of Cedar Grove."[59] Mr. Lebed was forced "to disgorge his illegal profits of $272,826, together with prejudgment interest of $12,174, for a total of $285,000."[60]

The SEC accused Mr. Lebed of illegal market manipulation. Specifically, he was charged with "using multiple fictitious names" in postings on "Yahoo Finance message boards

s-securities-and-exchange-commission-sec-enforcement-to-investigate-andrew-left-of-citron-research?original_footer_petition_id=7946693&algorithm=promoted&source_location=petition_footer&grid_position=3&pt=AVBldGl0aW9uAAff1wAAAAAAYAb9Y3ZgViU1NzJkMTJmNw%3D%3D [https://perma.cc/2XPX-ZP2D] (last visited Mar. 8, 2021).

[56] *See, e.g., generally* CITRON RSCH., *supra* note 53; Graffeo, *supra* note 54; Citron Rsch. (@Citron Research), TWITTER (Aug. 7, 2020, 10:52 AM) (on file with the Columbia Business Law Review), https://twitter.com/CitronResearch/status/1291749056440541186.

[57] In response to Citron's nefarious market actions, public opponents have been seeking ways to confront the firm via SEC and FINRA investigations and enforcement. *See, e.g.*, Samara, *supra* note 55.

[58] Press Release, U.S. Sec. & Exch. Comm'n, SEC Brings Fraud Charges in Internet Manipulation Scheme: Settlement Calls for Return of $285,000 in Illegal Gains (Sept. 20, 2000), https://www.sec.gov/news/press/2000-135.txt [https://perma.cc/XHR9-ETX4].

[59] Michael Lewis, *Jonathan Lebed's Extracurricular Activities*, N.Y. TIMES (Feb. 25, 2001), https://www.nytimes.com/2001/02/25/magazine/jonathan-lebed-s-extracurricular-activities.html [https://perma.cc/F8H3-B39F].

[60] *See* Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 58.

recommending [particular] stock[s] to others."[61] The SEC claimed that Mr. Lebed's postings had caused disorder in the stock market. "The average daily trading volume of the small companies he dealt in was about 60,000 shares; [however,] on the days" when Mr. Lebed "posted his messages, volume soared to more than a million shares."[62] Mr. Lebed, according to the SEC, had committed the sin of making money as a Main Street investor. Between September 1999 and February 2000, he generated daily profits (on the days that he traded) ranging from a low of $12,000 to a high of $74,000.[63] His actions ultimately led to total gains of $800,000.[64] The SEC settled for $285,000 of his profits in order to avoid litigating against a minor.[65]

Michael Lewis from *The New York Times* contacted the SEC to ask what Lebed had done wrong. It is a common fact that people generally use fictitious names on the Internet. Furthermore, "broadcasting one's private opinion of a stock on the Internet" is not a crime.[66] So why did the SEC go after Mr. Lebed? Lewis did not receive a response beyond being advised that the SEC thought young Mr. Lebed was "a little jerk."[67]

Even the most casual observer of capital market regulation can see "that in publicly touting stocks owned by his friends . . . Lebed was doing nothing different from what legions of Wall Street analysts did every day."[68] Yet the SEC does not conduct enforcement actions against legions of Wall Street analysts.[69] Unlike Mr. Lebed, it was Wall Street's job, and dominion, to practice that behavior. Mr. Lebed was a Main

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61 Lewis, *supra* note 59 (internal quotation marks omitted).

62 *Id.*

63 *Id.*

64 *Id.*

65 *See id.*

66 *Id.*

67 *Id.*

68 Steven Pearlstein, *GameStop Mania Exposes SEC's Failure as Regulator*, WASH. POST (Jan. 30, 2021, 6:57 PM), https://www.washingtonpost.com/business/2021/01/30/financial-regulations-wall-street-sec-GameStop [https://perma.cc/PUW5-8ZKU].

69 *See id.*

Street investor—and that distinction made all the difference in terms of securities regulation. When the SEC sued Jonathan Lebed, it abandoned any pretense of standing for fair, evenhanded regulation of trading markets.

It now appears that the SEC, state regulators, and even the Department of Justice are investigating whether the Main Street investors who posted on Reddit and traded GameStop shares engaged in illegal share price manipulation.[70] Throughout this investigation, the echoes of the SEC's Lebed enforcement action are loud and clear. The idea of investigating for stock market manipulation the very retail investors that the securities laws are supposed to protect is chilling. These investigations provide strong support for this Article's underlying hypothesis: regardless of the intentions of politicians, securities laws and regulation have the visceral and duplicitous effect of harming ordinary investors while benefitting various Wall Street elites.

The harm towards ordinary investors is instigated by the SEC's refusal to allow Main Street investors to do any business similar to that of the Wall Street elites—indirectly narrowing the high-stakes playing field. To this point, an obvious legal question emerges when considering the GameStop investigations: How can the postings about GameStop on the Reddit wallstreetbets forum be considered fraudulent and manipulative, while hedge funds' publication of bearish research reports about GameStop are not? The answer: there is no substantive difference between what short selling hedge funds were doing and what the Reddit users were doing.

Both the retail Reddit users and the hedge funds were publishing their views about share prices with the hope and expectation of influencing investor behavior so as to cultivate a

[70] *See, e.g.*, Dave Michaels, *GameStop Mania Is Focus of Federal Probes into Possible Manipulation*, WALL ST. J. (Feb. 11, 2021, 7:50 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/GameStop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950; Alex Padalka, *SEC Probing Social Media Posts for GameStop Price Manipulation*, FIN. ADVISOR: IQ (Feb. 5, 2021), https://financialadvisoriq.com/c/3051383/384013/probing_social_media_posts_GameStop_price_manipulation [https://perma.cc/PVC6-PHMT].

herd response that would cause a ripple effect on equity prices. These hedge funds are now known to "trumpet their short research on social media—a phenomenon that has turned the world of short-selling upside down over the past decade."[71] The hedge funds' strategy is simple. First, one sells short. Then, one publishes a negative research report. In following this strategy, "[t]he hope is that, once publicized, a damning report will be the catalyst for a downward move in a stock they've shorted."[72] Of particular concern is that hedge funds' negative "reports sometimes arrive just prior to the expiration of options that can send stocks into a tailspin."[73]

At most, the difference between what the hedge funds were doing with their negative reporting and what the Reddit crowd was doing with their posts was microscopic. It came down to two differences: (1) explicit intention and (2) motivation. First, people posting on Reddit were explicit about their hope to motivate others to buy GameStop by "urging more traders to buy shares . . ., exposing even more novice investors to the trend as shares surged higher."[74] Second, the Reddit posts sometimes were politically-driven, rather than analytically-based—a distinct motivation from their Wall Street counterparts. It was the proletariat versus the bourgeoisie, with "Reddit users . . . cheer[ing] the trade as a way to drive massive losses at short-selling hedge funds . . .[,] t[aking] on a

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[71] Michelle Celarier, *The Dark Money Secretly Bankrolling Activist Short-Sellers — and the Insiders Trying To Expose It*, INSTITUTIONAL INV. (Nov. 30, 2020), https://www.institutionalinvestor.com/article/b1pgz6k9kjs50v/The-Dark-Money-Secretly-Bankrolling-Activist-Short-Sellers-and-the-Insiders-Trying-to-Expose-It [https://perma.cc/YP4F-L4G8].

[72] *Id.*

[73] *Id.*

[74] Ben Winck, *The Reddit-Fueled GameStop Rally Is Reportedly Under Federal Investigation for Possible Market Manipulation—and Robinhood Has Been Subpoenaed*, BUS. INSIDER: MKTS. INSIDER (Feb. 11, 2021), https://markets.businessinsider.com/news/stocks/reddit-GameStop-stock-rally-investigation-market-manipulation-robinhood-regulation-gme-2021-2-1030074397 [https://perma.cc/5LM6-RPUQ].

populist tone that pitted the everyday trader against the Wall Street establishment."[75]

However, the principal difference was that of explicit intention: those posting on Reddit were explicit about trying to induce a wave of trading activity, while the hedge funds merely hinted at their desired outcome.[76] This difference holds little meaning when we consider why hedge funds followed their particular strategy of shorting and repudiating. There is a sole, obvious reason why a hedge fund would bother to post negative research about a company whose stock it was shorting: it intended to encourage other investors to drive the price of that company's shares downward, working to alter share prices just the same as the Reddit users.

The point here is not to criticize short selling. There is no question that short selling is highly beneficial to financial markets, as it promotes market efficiency by (1) speeding up price adjustments, (2) reducing bid-ask spreads, (3) moderating asset overvaluation, and (4) mitigating price distortions.[77] Short selling should also be encouraged as a method of reducing corporate wrongdoing, providing incentives for market participants to ferret out fraud.[78] Far from arguing that short selling is wrong or should be more strictly regulated, the point here is simply this: the relatively naïve investors posting on

[75] *Id*. Wall Street short sellers, by contrast, tend to speak about profits. *See, e.g.*, Celarier, *supra* note 71.

[76] Compare the Reddit users' directness with an attack tweet from Citron Research: "Without lengthy reports, Citron and others are providing both Chinese/ US authorities with enough info that can put an end to this charade. A shame that respectable companies like $TAL and $EDU are being losing [sic] market cap to $GSX. gsxstockfraud.com." Citron Rsch. (@Citron Research), *supra* note 56.

[77] *See* Oscar Bernal, Astrid Herinckx & Ariane Szafarz, *Which Short-Selling Regulation Is the Least Damaging to Market Efficiency? Evidence from Europe*, 37 INT'L REV. L. & ECON. 244, 244–45, 253 (2014); Douglas W. Diamond & Robert E. Verrecchia, *Constraints on Short-Selling and Asset Price Adjustment to Private Information*, 18 J. FIN. ECON. 277, 292 (1987).

[78] *See* Jonathan Macey, *Getting the Word out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1903 (2007) (contending that selling short "can credibly signal the market that the trader has negative information about a company").

Reddit should not be subject to more stringent regulations than the Wall Street hedge funds who receive expert legal advice about how to post negative comments without attracting the ire of regulators.

2. Robinhood and Market Fairness

The broker-dealer firm Robinhood was at the center of the trading[79] in what was one of the most actively-traded stocks in the world in early 2021, GameStop. 197,157,900 shares changed hands on the stock's most active day of trading, Friday, January 22, 2021.[80] Robinhood is known as a controversial online brokerage firm that promises its investors commission-free trades. However, it does so by selling its customers' order flow to high-frequency traders (HFTs) and market makers such as Citadel and Virtu Financial, sometimes without much in the way of disclosure.[81]

Scholars have noted that:

> Robinhood (RH) was founded in 2013 based on a business plan to make it easier and cheaper for small investors to participate in the stock and option markets. RH never charged brokerage fees, which allowed their clients to buy and sell single (and even fractional) shares of stocks. RH[] also appealed to customers with many other small technological innovations, such as a friendly mobile-first user interface. RH itself earns its own revenues through margin

79 *See supra* note 33 and accompanying text.

80 GameStop Corp. Historical Data, YAHOO!: FIN., https://finance.yahoo.com/quote/GME/history [https://perma.cc/DT42-US7H] (last visited Feb. 22, 2021).

81 Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges Robinhood Financial with Misleading Customers About Revenue Sources and Failing To Satisfy Duty of Best Execution (Dec. 17, 2020, https://www.sec.gov/news/press-release/2020-321 [https://perma.cc/4BX5-N82R]; Dave Michaels & Alexander Osipovich, *New SEC Chairman Sets Sights on Citadel Securities and Virtu*, WALL ST. J. (May 9, 2021, 12:00 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/new-sec-chairman-sets-sights-on-citadel-securities-and-virtu-11620576000.

> fees, cash balance interest, and payment-for-order flow.[82]

Robinhood has about 13 million retail investor clients.[83] Although it is a private company, Robinhood has a reported value of $11.2 billion.[84] Its retail customers are thought to be primarily "small, young, computer-savvy but novice investors."[85] In fact, Robinhood has told journalists that "first-time investors accounted for 1.5 million of its 3 million funded accounts opened in the first four months of 2020."[86] Traders on Robinhood typically make modest investments in equity securities, reportedly about $2,000 on average.[87]

Despite its predominantly novice clientele and modest investments, Robinhood has become a disruptive force on the investing landscape. The company's rapid growth is said to have led other rival brokerage firms to abandon brokerage fees so that they can continue competing for investor client bases.[88] The company's success is also reputed to have helped induce the merger between Charles Schwab and Ameritrade.[89]

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[82] Ivo Welch, *The Wisdom of the Robinhood Crowd* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 27866, 2020), https://www.nber.org/system/files/working_papers/w27866/w27866.pdf [https://perma.cc/5FNR-F3B6].

[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] Laura Saunders & Mischa Frankl-Duval, *The Tax Moves Day Traders Need To Make Now*, WALL ST. J. (on file with the Columbia Business Law Review), https://www.wsj.com/articles/the-tax-moves-day-traders-need-to-make-now-11599816642 (last updated Sept. 11, 2020, 2:36 PM).

[87] *See* Welch, *supra* note 82, at 2.

[88] *Id.* at 2, 8.

[89] *Id.* at 8; *see also* Press Release, Charles Schwab Corp., Schwab Completes Acquisition of TD Ameritrade (Oct. 6, 2020), https://www.businesswire.com/news/home/20201006005590/en/Schwab-Completes-Acquisition-of-TD-Ameritrade [https://perma.cc/2LXC-LVN2]; Tyler Clifford, *Jim Cramer: Robinhood Pushed Charles Schwab To Deal for TD Ameritrade*, CNBC, https://www.cnbc.com/2019/11/21/jim-cramer-robinhood-pushed-charles-schwab-to-deal-for-td-ameritrade.html [https://perma.cc/R9EJ-3CBU] (last updated Nov. 21, 2019, 7:20 PM) (reporting that TV personality Jim Cramer stated that "Robinhood and the 'creative disruption unleashed

In an important article on the effects that Robinhood's retail investors have on the capital markets, Ivo Welch observed millions of Robinhood trades from June 1, 2018 to September 30, 2020.[90] Welch found that Robinhood investors invested somewhat idiosyncratically compared with professional investors, as displayed in their noteworthy investments in the physical infrastructure and cannabis company India Globalization Capital, Inc. (IGC).[91] This company has also attracted the attention of regulators for making claims about the efficacy of cannabis in treating Alzheimer's disease.[92] But as a whole, Robinhood retail investors mainly invested in the more traditional stocks of large capital issuers such as "Disney, G[eneral Electric], Ford, and airline stocks," particularly American Airlines.[93] The more traditional investments tended to be among businesses that were familiar to retail consumers[94] and supplied "products familiar to computer-savvy Millennials."[95]

In a nutshell, while Robinhood retail investors were not outperforming the market, they did not perform badly.[96] In fact, Robinhood investors had a stabilizing effect on the market during the turbulence surrounding the early days of the Covid-19 pandemic, when the market dropped in value by one-third.[97] During this time period

by Silicon Valley' forced the potential merger between Charles Schwab and TD Ameritrade").

90 *See* Welch, *supra* note 82, at 9–10.

91 *Id*. at 22 ("It is difficult to think of a rational portfolio in which IGC would deserve an investment weight similar to that of J.P. Morgan.").

92 Press Release, U.S. Sec. & Exch. Comm'n, SEC Files Settled Charges Against India Globalization Capital and Its CEO for Disclosures Regarding Availability of Its First Cannabis Product (Dec. 21, 2020), https://www.sec.gov/enforce/33-10908-s [https://perma.cc/S8SF-NUDN] (announcing an order finding that IGC misrepresented the speed with which its planned Alzheimer's product would be available).

93 *See* Welch, *supra* note 82, at 25.

94 *Id*. at 26.

95 *Id*. at 24.

96 *Id*. at 32.

97 *See* Amrith Ramkumar, *From Stocks to Bitcoin, Investors Bet the 'Everything Rally' Will Continue*, WALL ST. J. (Jan. 3, 2021, 5:30 AM) (on file

> R[obinhood] investors not only increased their relative holdings in individual stocks when their stock prices increased or decreased greatly, but also increased their overall holdings . . . . They did not panic. They added more positions four days after market increases or decreases, suggesting that they transferred funding to their RH accounts in response to volatility. In March 2020, they were thus a (small) stabilizing force. Given the subsequent rise in the stock market, their timing and steadfastness contributed to their good portfolio returns—as did their general increase in participation from 2018 to 2020.[98]

The retail investors had given Robinhood visibility and competitiveness, while also providing market stabilization and continued profit to Robinhood during a debilitating global catastrophe.[99] Yet on January 28, 2021, Robinhood—whatever its motivation—took action that greatly favored its hedge fund clients who paid it for order flow. Robinhood did this by allowing sales, but not purchases, of GameStop shares (and of certain other companies', including AMC, Blackberry, Bed Bath and Beyond, and Nokia).[100]

It is unlikely that the GameStop investors utilizing Robinhood were receiving the best possible execution of their orders. Robinhood's business model is based on the common, but opaque, practice of payment for order flow. Robinhood is able

with the Columbia Business Law Review), https://www.wsj.com/articles/from-stocks-to-bitcoin-investors-bet-the-everything-rally-will-continue-11609669800 ("The S&P 500 ended the year up 68% from its March lows, after losing more than one-third of its value in about a month.").

98 *Id.*

99 Robinhood's precise profits are unclear, but its first quarter revenues in 2021 ($331 million) more than tripled its results in the first quarter of 2020 ($91 million). *See* Avi Salzman, *Robinhood Filing Shows Enormous Growth in Controversial Revenue Source*, BARRON'S (May 3, 2021, 2:11 PM) (on file with the Columbia Business Law Review), https://www.barrons.com/articles/robinhood-filing-shows-enormous-growth-in-controversial-revenue-source-51620065477.

100 *See* Christy Bieber, *Why Did Robinhood Shut down GameStop Trading?*, THE ASCENT (Jan. 28, 2021), https://www.fool.com/the-ascent/buying-stocks/articles/why-did-robinhood-shut-down-gamestop-trading/ [https://perma.cc/J2CG-7MXH].

to execute trades for customers without charging them fees or commissions because third parties, usually high-frequency trading firms, compensate Robinhood for directing to them orders received by the broker-dealer. Customers, even sophisticated customers who place orders to buy or sell securities online or in person, generally do not consider how the broker-dealer executes their orders. They believe the order is sent to the stock exchange where the security is listed.[101] Yet broker-dealers rarely do this. Instead, broker-dealers send the order to a high-frequency trading firm (referred to as a "wholesaler") such as Robinhood's biggest client, Citadel Securities.[102] Citadel then either executes the trade or executes against existing bids and offers in the market.[103]

Thus, Robinhood is not a middleman between retail investors and the stock exchange; rather, the firm direct trades to whatever venue provides it with the highest payment for its order flow. Payment for order flow was a technique invented by the notorious fraudster Bernie Madoff.[104] Using this technique, self-proclaimed discount brokers would take the fees received for their order flow and charge low, "discount" fees to clients.[105] Payment for order flow can thus result in trades being directed to venues that pay the most for order flow but do not necessarily offer customers the best prices. In other words, the duty of best execution does not always work. The cost

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[101] *Cf.* Kate Rooney & Maggie Fitzgerald, *Here's How Robinhood Is Raking in Record Cash on Customer Trades—Despite Making It Free*, CNBC, https://www.cnbc.com/2020/08/13/how-robinhood-makes-money-on-customer-trades-despite-making-it-free.html [https://perma.cc/J99W-EC3K] (last updated Aug. 14, 2020, 10:17 AM) (summarizing complaints about the transparency of payments for order flow).

[102] *See* Douglas MacMillan & Yeganeh Torbati, *Robinhood and Citadel's Relationship Comes into Focus as Washington Vows To Examine Stock-Market Moves*, WASH. POST (Jan. 29, 2021, 5:49 PM), https://www.washingtonpost.com/business/2021/01/29/robinhood-citadel-gamestop-reddit/ [https://perma.cc/MS99-3R3T].

[103] *See id.*

[104] Annie Massa, *Payment for Order Flow*, BLOOMBERG, https://www.bloomberg.com/quicktake/payment-for-order-flow [https://perma.cc/GK9J-BNG3] (last updated Mar. 9, 2017, 4:49 PM).

[105] *Id.*

savings that customers receive from free commissions may be offset by a "potentially greater cost in the form of inferior execution quality."[106]

The technique's poor execution quality and lack of transparency prompted the United Kingdom's financial authority to ban payment for order flow in 2012.[107] *Barron's* reported that when payment for order flow was banned, "[t]rades executed at the best quoted prices jumped from 65% to more than 90% between 2010 and 2014."[108] The major reason why other jurisdictions have banned payment for order flow, however, is because the practice "creates a conflict of interest between a firm [such as Robinhood] and its [retail] clients."[109] This conflict arises from the firm being "incentivised to pursue payments from market makers rather than to provide best execution in the interests of their clients."[110] Moreover, payment for order flow "undermines the transparency and efficiency of the price formation process . . . because the prices paid by clients include hidden costs [such as] . . . the higher spread that they may additionally need to pay to take account of the fees paid by the market maker."[111] Payment for order flow "[f]orc[es] market makers to 'pay-to-play' . . . [and thus] distort[s] competition by creating barriers to entry and expansion."[112]

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[106] Stanislav Dolgopolov, *The Role of the Duty of Best Execution in Off-Exchange Market Making: Persistent Issues and Their Emerging Iterations*, MEDIUM (Nov. 13, 2020), https://medium.com/@s_v_dolgopolov/the-role-of-the-duty-of-best-execution-in-off-exchange-market-making-persistent-issues-and-their-460b7e9971a9 [https://perma.cc/F4TE-BWDR].

[107] FIN. SERVS. AUTH., GUIDANCE ON THE PRACTICE OF 'PAYMENT FOR ORDER FLOW' 1 (2012), https://www.fca.org.uk/publication/finalised-guidance/fg12-13.pdf [https://perma.cc/K6F5-6TTH] (instructing that payment for order flow generally is impermissible).

[108] Daren Fonda, *There Are More Ways To Trade Stocks for Free. But There's a Catch*, BARRON'S (Oct. 1, 2019, 7:30 AM), https://www.barrons.com/articles/there-are-more-ways-to-trade-stocks-for-free-but-theres-a-catch-51569929400 [https://perma.cc/RTR8-G32Q].

[109] *See* FIN. CONDUCT AUTH., MKT. WATCH NO. 51, OBSERVATIONS FROM MARKET MAKER REVIEW 5 (2016), https://www.fca.org.uk/publication/newsletters/marketwatch-51.pdf [https://perma.cc/HZN8-KWP3].

[110] *Id.*

[111] *Id.*

[112] *Id.*

The SEC's Regulation National Market System (Reg NMS) requires that customers receive the NBBO, or the National Best Bid, Best Offer, at a minimum.[113] This means that customers must receive the best publicly available price. The issue with payment for order flow is that it becomes difficult to determine whether this technique limits customers' ability to get a better deal on particular trades.

Commentators have pointed out that HFTs that pay for order flow actually transfer wealth from retail traders to themselves in ways that (1) undermine market quality and (2) result in customers receiving suboptimal trade execution quality. One such wealth-transfer practice is order bundling. Order bundling occurs when several clients at the same brokerage place a buy order on the same stock at about the same time. Instead of processing the orders separately for each client, wholesalers will bundle all of those orders into one. These bundled offers often give HFTs "certain [valuable] information about future short-term price movements."[114] Since "retail traders are generally less informed than their institutional counterparts, wholesalers will often take the opposite side of the trade, if the institutional flow is moving in that direction."[115]

Another wealth-transfer practice is latency arbitrage. The HFTs who interact with slower retail traders on Robinhood essentially free ride off of the information in the retail traders' orders. The HFTs will thus act on available information signals faster than the retail investors are able to.[116] This practice has been labeled 'toxic arbitrage' and is thought to reduce

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[113] 17 C.F.R. § 242.611(a) (2020).

[114] WARRIOR TRADING, *A Primer on Payment for Order Flow: Brokers Selling Orders to HFTs*, https://www.warriortrading.com/payment-for-order-flow [https://perma.cc/KS7L-55DH].

[115] *Id.*

[116] *See* Robert P. Bartlett III & Justin McCrary, *How Rigged Are Stock Markets? Evidence From Microsecond Timestamps*, 45 J. FIN. MKTS. 37, 37–38 (2019).

liquidity in financial markets by increasing adverse selection to liquidity providers.[117]

Given Robinhood's tendency to facilitate the above-mentioned practices, it has been identified as a bad actor even among discount brokers, who execute trades at zero or low commissions but do not provide investment advice. In a recent enforcement action, the SEC determined that "between 2015 and late 2018, Robinhood made misleading statements and omissions in customer communications, including in FAQ pages on its website, about its largest revenue source."[118] The company declined to describe how it made money—namely, through the practice of payment for order flow.[119] "As the SEC's order f[ound], one of Robinhood's selling points to customers was that trading was 'commission free.'"[120] Yet, "due in large part to its unusually high payment for order flow rates, Robinhood customers' orders were executed at prices that were inferior to other brokers' prices."[121] Despite this inferiority, the order continued, "Robinhood falsely claimed in a website FAQ between October 2018 and June 2019 that its execution quality matched or beat that of its competitors."[122] The order determined "that Robinhood provided inferior trade prices that in aggregate deprived customers of $34.1 million."[123] More significantly, that number was calculated *after* taking into account customers' savings from not paying a commission.[124] Robinhood continued to make similar false and misleading statements throughout its growth to attract more customers, while refusing to disclose the truth behind

[117] *See* Matteo Aquilina et al., Dark Pool Reference Price Latency Arbitrage 2 (May 10, 2017) (unpublished manuscript), https://ifrogs.org/PDF/CONF_2017/Aquilina_Foley_Oneill_Ruf_2017.pdf [https://perma.cc/Q2BP-WQ4W].

[118] *See* Press Release, U.S. Sec. & Exch. Comm'n, *supra* note 81.

[119] *See id.*

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Id.*

its business model.[125] Ultimately, Robinhood was forced to pay a fine of $65 million for its role in such abusive market practices.[126]

All this considered, it is ironic that Robinhood has tried to pass itself off as a friend to the little guy.[127] It never has been. One silver lining in the Reddit/GameStop saga is that the company may finally have been exposed as just another cog rigged against the little guy in the unfair system of securities regulation, capital markets, and trading.[128]

B. Orderly Markets: Trading Halts and Complex Order Types

Markets are by nature disorderly.[129] Moreover, attempts to make markets more orderly tend to disadvantage Main Street investors and benefit Wall Street market professionals, as we saw when Robinhood stopped trading in GameStop shares.[130] In this Section, I discuss two ways that securities regulation has harmed Main Street investors under the guise of creating "orderly" markets. The first is by allowing trading halts. The second is by allowing complex order types that

125 *See id.*

126 *Id.*

127 *See About Us*, ROBINHOOD, https://robinhood.com/us/en/about-us/ [https://perma.cc/5KNL-FBNB] (last visited May 21, 2021) ("We're on a mission to democratize finance for all.").

128 *See* Jonathan Macey & David Swensen, *Wall Street Profits by Putting Investors in the Slow Lane*, N.Y. TIMES (July 18, 2017), https://www.nytimes.com/2017/07/18/opinion/wall-street-brokers-rebates-kickbacks.html [https://perma.cc/3V53-VVP2].

129 Market crashes that occur without warning or apparent justification are, perhaps, the best example of the inherent disorderliness of markets. *See generally* DIV. OF MKT. REGUL., U.S. SEC. & EXCH. COMM'N, THE OCTOBER 1987 MARKET BREAK (1988); Daniel R. Fischel, *Efficient Capital Markets, the Crash, and the Fraud on the Market Theory*, 74 CORNELL L. REV. 907 (1989); Jerry W. Markham & Rita McCloy Stephanz, *The Stock Market Crash of 1987—The United States Looks at New Recommendations*, 76 GEO. L.J. 1993 (1988).

130 *See supra* text accompanying notes 32–36.

benefit Wall Street professionals, particularly HFTs, at the expense of ordinary investors.[131]

1. Trading Halts

Trading halts are a classic way that regulators attempt to make securities markets orderly.[132] Trading halts can either stop trading on all securities, or they can apply to trading on a particular security.[133] In either case, such halts are problematic.

The argument in favor of market halts is that "excessive" market volatility is inconsistent with the concept of orderly markets.[134] Thus, trading halts bring extreme order to the securities markets by reducing volatility to zero.

"Stock markets, exchanges and the SEC are authorized to suspend trading on individual securities to protect investors and level the field between informed, reactive traders and those lagging on relevant news."[135] In addition to halting trading when there is significant volatility in share prices, trading

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131 *See* SCOTT PATTERSON, DARK POOLS: THE RISE OF THE MACHINE TRADERS AND THE RIGGING OF THE U.S. STOCK MARKET 204–05 (2013) ("High-speed firms worked hand in hand with the trading networks to create exotic order types that would behave in very specific ways.").

132 *See* Caroline Bradley, *Suspension and Disbelief (or, How Managed Should a Market Be?)*, 26 SETON HALL L. REV. 597, 598 (1996).

133 *See id.*

134 *See* Tamar Frankel, *What Can Be Done About Stock Market Volatility*, 69 B.U. L. REV. 991, 995–96 (1989) (objecting to market halts as a solution to high volatility).

135 Elizabeth Balboa, *Trading Halts 101: What To Know About Your Stock, Circuit Breakers and More*, YAHOO!: FIN. (Jan. 27, 2021), https://finance.yahoo.com/news/trading-halts-101-know-stock-160000785.html [https://perma.cc/772P-DAZ6]. Trading halts are specifically authorized by the Securities Exchange Act of 1934. 15 U.S.C. § 78*l*(k) (2019). The principal architecture of today's rules comes from the Market Reform Act of 1990, Pub. L. No. 101-432, § 2, 104 Stat. 963, 963–64 (codified as amended at 15 U.S.C. § 78*l*(k)), and the Intelligence Reform and Terrorism Prevention Act of 2004, Pub. L. No. 108-458, sec. 7803, § 12(k)(2), 118 Stat. 3638, 3861–63 (codified at 15 U.S.C. § 78*l*(k)(2)). In addition, the stock exchanges may halt trading pursuant to section 12(d) of the Securities Exchange Act, 15 U.S.C. § 78*l*(d), and 17 C.F.R. § 240.12d2-1 (2020). *See also* NYSE R. 7.12 (N.Y. Stock Exch. 2020) (providing for NYSE trading halts under a pilot scheme).

halts may occur when companies have major news to report.[136]

The essential goal of these halts—to make markets "orderly" in the face of volatility—requires eliminating the markets themselves for a certain period of time. They are akin to the military strategy of "destroying the village in order to save it."[137] As George Stigler observed decades ago, trading halts should be considered indefensible because they are based on the untenable assumption that the Wall Street professionals who order such halts actually know what the "correct prices" are for the securities under examination. Stigler stated:

> The popular NYSE practice of suspending trading until buy and sell orders can be matched at a "reasonable" price is open to serious objection. To prevent a trade is no function of the exchange, and any defense must lie in a desire to avoid "unnecessary" price fluctuations. . . . This suspension of trading means that the exchange officials know the correct price change when there is a flood of buy or sell orders. We need not pause to inquire where they get this clairvoyance; it is enough to notice that the correct way to iron out the unnecessary wrinkles in the price chart is to speculate: to buy or sell against the unnecessary movement. The omniscient officials should be deprived of the power to suspend trading but given vast sums to speculate.[138]

As Caroline Bradley presciently observed, "[o]f the costs imposed by suspensions, the most significant are those imposed on shareholders of the suspended issuer who are deprived by the suspension of a market for their securities, and

136 *See, e.g.*, 15 U.S.C. § 78*l*(k)(1).

137 *See* Stephen L. Carter, *Destroying a Quote's History in Order To Save It*, BLOOMBERG (Feb. 9, 2018, 2:50 PM), https://www.bloomberg.com/opinion/articles/2018-02-09/destroying-a-quote-s-history-in-order-to-save-it [https://perma.cc/8AHF-675Z] (describing the history of the phrase).

138 George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 741 (1964).

locked in to the issuer."[139] The benefits of trading halts then flow disproportionately to market professionals, with the costs being largely borne by market participants.[140]

Market professionals on Wall Street make money by purchasing securities at the low "bid" price and selling them at the higher "offered" price. As volatility increases, the risks to certain Wall Street market professionals from dealing in securities also increase. Under normal market conditions, market professionals can easily handle volatility simply by increasing the spread between their bids and offers for securities. But in times of extreme price volatility, trading halts are necessary to curb market professionals' losses. Put simply, trading halts allow market professionals time to search for the new, "correct" price levels that such volatility generally signals.[141]

2. Complex Order Types

Traditionally, market participants have entered either (1) market orders, which are orders to buy or sell at the best market price currently available, or (2) limit orders, which are orders to buy or sell when the market moves to the particular price specified in the limit order.[142] However, as previously observed, the SEC has benefitted HFTs and stock exchanges at the expense of ordinary Main Street investors.[143] They have done so by allowing HFTs to create a multitude of bespoke types of trading orders that disrupt the orderly execution of retail investors' orders.[144]

So-called "Hide Not Slide" orders are but one example of the way in which regulators have allowed HFTs to undermine

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[139] Bradley, *supra* note 132, at 622.

[140] *See id.* at 621–22.

[141] *See* William G. Christie, Shane A. Corwin & Jeffrey H. Harris, *Nasdaq Trading Halts: The Impact of Market Mechanisms on Prices, Trading Activity, and Execution Costs*, 57 J. FIN. 1443, 1443 (2002).

[142] Sugato Chakravarty & Craig W. Holden, *An Integrated Model of Market and Limit Orders*, 4 J. FIN. INTERMEDIATION 213, 213 & n.1 (1995).

[143] Macey & Swensen, *supra* note 128.

[144] Jonathan Macey & David Swensen, *Recovering the Promise of a Fair and Orderly Stock Exchange*, 42 J. CORP. L. 777, 787 (2017).

the concept of orderly markets. Hide Not Slide orders are based on two sets of regulations: (1) regulations that stipulate that whenever the best bid price and the best offer price for a security are identical across all exchanges, the market is deemed to be "locked," and (2) regulations that require that orders at the same price be executed in the order in which they are received.[145]

When markets are locked, trading cannot occur until the markets become unlocked. One way that markets become unlocked is for the bid to "slide" back to a lower bid price.[146] "Hide Not Slide Orders allow HFTs to enter orders that lock markets and [to] hide" such bids from display.[147] If a trade is executed later at the (higher) offer price, the HFT's previously hidden bid will be displayed because the higher offer means that the bid no longer locks the market. Since the HFT's bid was entered earlier, it will now be first in line to be executed—"even ahead of [a] previous higher bid that slid down to a slightly lower price. The Hide Not Slide scheme allows HFTs to jump ahead of ordinary investors placing [traditional] buy orders."[148]

In other words, Hide Not Slide Orders provide a means by which HFTs can simultaneously achieve an unfair trading advantage over ordinary investors and undermine fair and orderly markets by allowing HFTs to jump ahead of the orders of ordinary investors.

C. Efficiency

Regulators appear to have a preoccupation with market efficiency.[149] According to the efficient capital markets hypothesis (ECMH), capital markets are more or less efficient

[145] Scott Patterson & Jenny Strasburg, *How 'Hide Not Slide' Orders Work*, WALL ST. J. (Sept. 18, 2012, 10:40 PM) (on file with the Columbia Business Law Review), https://www.wsj.com/articles/SB10000872396390444812704577605840263150860.

[146] *See id.*

[147] Macey & Swensen, *supra* note 144, at 787.

[148] *Id.*

[149] Bradley, *supra* note 3, at 75.

depending on the extent to which the prices of traded securities fully and instantaneously reflect all information relevant to determining the value (i.e., the present value of the future income stream) generated for investors.[150]

Writing from a law and economics perspective, Frank Easterbrook and Dan Fischel have identified the achievement of efficient capital markets as the goal of securities regulation:

> The stated objective of securities law is to make markets function efficiently—not to redistribute income or reshape preferences. True, people sometimes say that the function of securities law is "the protection of investors" or "compensation for wrongs," but these are just restatements of the objective of efficient operation of the markets. When markets efficiently respond to information, the price of securities adjusts, and this protects all investors—even uninformed ones.[151]

Writing from a more regulatory perspective, Ronald Gilson and Reinier Kraakman have observed that the ECMH is "the context in which serious discussion of the regulation of financial markets takes place."[152]

While scholars and policymakers fully understand that the concept of efficient capital markets is analytically profound, few grasp the practical implications of the hypothesis for securities regulation. But these practical implications are existential. If capital markets were actually efficient, there would

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[150] *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) [hereinafter Fama, *Efficient Capital Markets*]; Eugene F. Fama, *Reply*, 31 J. FIN. 143, 143 (1976) ("Market efficiency then requires that in setting prices . . . , the market correctly uses all available information[.]").

[151] Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 613 (1985) (citing Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and The Protection of Investors*, 70 VA. L. REV. 669, 693–94 (1984)); *see also* Bradley, *supra* note 132, at 601 ("The debate about how securities markets should be regulated is no longer simply a debate about the best way to eliminate market abuses, but is a debate about whether regulation should and can be designed to promote market efficiency.").

[152] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 550 (1984) (emphasis deleted).

be no need for securities regulation because share prices would protect investors, thereby obviating the problems of fraud and poor execution quality. In other words, as the capital markets become more efficient, they in turn become less dependent on external securities regulation.

In addition, the ECMH's concept of informational efficiency has deep implications for the concept of orderly financial markets. Simply put, as capital markets become more efficient, they become less orderly. Andrew Lo has eloquently observed that the ECMH has a "Zen-like, counter-intuitive flavour to it: the more efficient the market, the more random the sequence of price changes generated by such a market, and the most efficient market of all is one in which price changes are completely random and unpredictable."[153]

Perhaps most importantly, if markets were perfectly efficient, then shady corporate managers could not commit fraud by manipulating their accounting results, or in any other way. Securities prices would consistently reflect the company's true performance based on market information, rather than the false results reported by management.[154]

Of course, markets are not perfectly efficient. But they are very efficient. To see just how efficient capital markets are, it is necessary to understand the ways that the concept of capital markets efficiency is framed—through the strength of securities prices. Specifically, securities prices may be viewed as (1) weak-form efficient, (2) semi-strong-form efficient, or (3) strong-form efficient.

The weak form of the ECMH postulates that a stock's price reflects all historical information, and, as such, share prices are independent of past price performance. In other words, weak-form efficiency posits that whatever information is contained in the historic progression of a company's stock price is reflected in the current price.[155]

[153] Andrew W. Lo, *Efficient Markets Hypothesis*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS (living ed. 2017).

[154] *See* William H. Beaver, *Market Efficiency*, 56 ACCT. REV. 23, 28 (1981).

[155] JAMES H. LORIE, PETER DODD & MARY HAMILTON KIMPTON, THE STOCK MARKET: THEORIES AND EVIDENCE 56 (2d ed. 1985). The weak form of

The semi-strong form of the ECMH is what people generally mean when they talk about efficient capital markets. As Michael Jensen observed, "the Semistrong Form of the [ECMH] represents the accepted paradigm and is what is generally meant by unqualified references in the literature to the 'Efficient Market Hypothesis.'"[156] The semi-strong form of the ECMH makes a stronger claim about efficiency than the weak form, positing "that current prices fully reflect public knowledge . . . and that efforts to acquire and analyze this knowledge cannot be expected to produce superior investment results."[157]

Finally, the strong form of the ECMH takes the market idea to its limit. It asserts that both public and private information are fully and instantaneously reflected in the price of a stock.[158] Thus, no investor should be able to outperform the market systematically because the market incorporates all possible information into the stock price. Nobody has seriously contended that stock markets are strong-form efficient because it is unrealistic given the practical considerations of securities fraud.[159] If the stock markets were strong-form efficient, then insider trading would not be profitable. Prices would already have adjusted to reflect any non-public information an insider might have before the insider could trade on the basis of that information.[160]

the ECMH is also known as the "random walk" theory. It implies that successive price movements of a security are independent of each other, and therefore security prices follow a random walk. *Id.* at 56–57.

[156] Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 97 (1978).

[157] LORIE ET AL., *supra* note 155, at 56.

[158] *Id.*

[159] Michael Jensen observed that "the Strong Form of the Efficient Market Hypothesis, is an extreme form which few people have ever treated as anything other than a logical completion of the set of possible hypotheses." Jensen, *supra* note 156, at 97.

[160] *See* Fama, *Efficient Capital Markets*, *supra* note 150, at 309–10; Joseph E. Finnerty, *Insiders and Market Efficiency*, 31 J. FIN. 1141, 1148 (1976) ("Insiders are able to outperform the market. Insiders can and do identify profitable as well as unprofitable situations within their corporations. This finding tends to refute the strong-form of the efficient market

The evidence that stock markets are semi-strong-form efficient is so well-established that economists have observed that "there is no other proposition in economics which has more solid empirical evidence supporting it."[161] To the extent that markets are semi-strong efficient, neither fundamental analysis nor technical analysis of equity securities can be profitable, and insider trading is the only way to earn "abnormal" returns. In a world in which securities prices are semi-strong efficient, it would be irrational to try to pick stocks that will outperform the market (unless one is in possession of material nonpublic information). Share prices will already reflect whatever information is providing the basis for one's trading strategy. Therefore, the costs of ferreting out such information and translating it into a trading strategy will be wasted.

Moreover, basic portfolio theory teaches that "idiosyncratic," or firm-specific, risks—which are the risks associated with a particular investment (such as the risk that a company's patent will be deemed invalid, or that its CEO will leave the company unexpectedly)—can be virtually eliminated by holding individual investments as part of a diversified portfolio.[162] The implications of these basic facts of corporate finance for securities regulation are profound.

First, the recognition that securities markets are efficient reveals that securities laws are constructed around a flawed premise. The securities laws are based on the premise that by making disclosure of firm-specific information mandatory, individual investors will be able to read and digest such

hypothesis."); Markus K. Brunnermier, Princeton Univ., Lecture 10: Market Efficiency 25 (2015), https://scholar.princeton.edu/sites/default/files/13lecture.pdf [https://perma.cc/G2NB-RDS6] ("[M]arkets cannot be strong-form informationally efficient, since agents who collect costly information have to be compensated with trading profits.").

161 Jensen, *supra* note 156, at 95 (noting however, that some contrary evidence exists).

162 *Modern Portfolio Theory (MPT)*, CORP. FIN. INST., https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/modern-portfolio-theory-mpt/ [https://perma.cc/BK3E-3JNZ] (last visited Apr. 2, 2021) ("The idiosyncratic risk associated with the portfolio is lower or negligible if it's diversified. It is because any loss in one asset is likely to be offset by a gain in another asset (which is negatively correlated).").

required disclosure and then pick individual stocks based on their analyses.[163] In fact, this is precisely the opposite of what investors should be doing. Investors should not be trying to educate themselves about firm-specific investment risks. Instead, investors should be trying to eliminate the firm-specific risks associated with stock-picking by investing in diversified mutual funds whose returns are based on broad market indices.

Thus, if the SEC were regulating in the public interest, it would focus on promulgating regulations that make the capital markets more efficient. Efficient capital markets would be fair because individual investors who buy securities priced efficiently receive financial assets whose value reflects all available information about the risks and returns associated with those assets. Put simply, efficient capital markets would allow investors to rely on securities prices.

It is understandable why the SEC does not regulate in this way. From a political science point of view, efficient markets pose an existential threat to regulators. In semi-strong efficient markets, the vast majority of securities regulation becomes obsolete. Given this existential threat, the SEC is clearly regulating in ways that are consistent with its own private bureaucratic interests, rather than in the interests of investors. It has clung to antiquated views about investing, promoting regulations that have undermined rather than facilitated efforts to make capital markets more efficient.

To fully grasp the SEC's role in undermining the efficiency of capital markets, one must first understand how securities markets become efficient in the first place. Securities markets become efficient through arbitrage. Market professionals, like securities analysts at banks and hedge funds, compete to find mispriced securities. These market professionals "devote their careers to acquiring information and honing evaluative skills."[164] The buying and selling by these informed

[163] *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 326–29 (1979).

[164] Gilson & Kraakman, *supra* note 152, at 571.

investment professionals ensures that all relevant information about securities is rapidly transformed into price.[165]

The SEC, however, has been hostile to the work of securities analysts. In one famous case, a securities analyst who successfully ferreted out a major fraud at a large insurance company was in fact sued by the SEC for insider trading.[166] In that case, the Supreme Court stepped in to repel the SEC's efforts to undermine the integrity of the capital markets. When discussing the Supreme Court's rejection of the SEC's treatment of stock market analysts in *Dirks v. SEC*, Adam Pritchard noted that the Court "wanted to leave space for securities professionals to uncover nonpublic information, even if it came from corporate insiders."[167] As the Court itself explained, the SEC's approach to insider trading "could have an inhibiting influence on the role of market analysts," who are "necessary to the preservation of a healthy market."[168] The Court went on to say:

> It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.[169]

165 Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 928 (1994).

166 Dirks v. SEC, 463 U.S. 646, 648–51 (1983).

167 A.C. Pritchard, Dirks *and the Genesis of Personal Benefit*, 68 SMU L. REV. 857, 861 (2015).

168 *Dirks*, 463 U.S. at 658.

169 *Id.* at 658–59 (citation omitted) (quoting Raymond L. Dirks, 21 S.E.C. 1401, 1406 (1981), *aff'd sub nom.* Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646).

The SEC's Regulation FD[170] is another example of a rule that undermines market efficiency. Regulation FD ("Reg FD" or Regulation "Fair Disclosure") undermines the work of stock market analysts by prohibiting public companies from engaging in what is known as "selective disclosure."[171] Selective disclosure is the practice of disclosing material information to a small, select number of securities analysts—rather than making such disclosures to all market participants through press releases or webcasts.

Reg FD erodes market efficiency by reducing the quantity and the quality of information that companies reveal about themselves. It eliminates the ability of companies to have one-on-one meetings with securities analysts at which they can provide context to the more general, anodyne disclosures that are made to the public. As the Securities Industry Association[172] shared in a letter opposing Reg FD: "we believe that these communications help get information into the marketplace, whereas [Reg FD] will discourage issuers from exchanging ideas or information with analysts, as well as deter analysts from vigorously competing to glean useful information for their clients and the markets."[173]

> The SIA also conducted a survey by interviewing 30 analysts. Of the analysts interviewed by the SIA, 47 percent felt that companies engaged in less communication during the post-FD period, and 72 percent felt that information communicated by issuers to the public was of lower quality in the post-FD period.[174]

[170] 17 C.F.R. §§ 243.100–.103 (2020).

[171] *See id.* § 243.100(a).

[172] The Securities Industry Association is a trade group representing financial analysts and securities professionals. *About SIA*, SEC. INDUS. ASS'N, https://www.securityindustry.org/about [https://perma.cc/2ZGE-RTXW] (last visited Apr. 2, 2021).

[173] Sec. Indus. Ass'n, Comment Letter on Proposed Regulation FD, (Apr. 6, 2000), https://www.sec.gov/rules/proposed/s73199/spencer1.htm [https://perma.cc/9GRM-Y65S].

[174] Partha S. Mohanram & Shyam V. Sunder, *How Has Regulation FD Affected the Operations of Financial Analysts?*, 23 CONTEMP. ACCT. RSCH.

Reg FD likely has had a particularly detrimental effect on the efficiency of securities pricing for smaller companies. Smaller companies, of course, have fewer shares outstanding, and the market for those shares is less liquid than the market for the shares of larger companies. As such, smaller companies have a harder time attracting analyst coverage. As Zohar Goshen and Gideon Parchomovsky have observed, small firms have a particular interest in engaging in selective disclosure of information to maintain and/or attract an analyst following, since small firm liquidity may be so low that the costs of obtaining private information may be higher than the gains from selling or trading on private information.[175]

Prior to the promulgation of Reg FD, the financial officers and corporate communications officials of smaller companies could attract analyst coverage by rewarding analysts who covered their firms with selective disclosure. Reg FD eliminated this practice. As Armando Gomes, Gary Gorton, and Leonardo Madureira have shown, "the adoption of Reg FD caused a significant reallocation of information-producing resources, resulting in a welfare loss for small firms, which now face a higher cost of capital."[176] Furthermore, they found that the reduction in corporate disclosures caused by Reg FD "was more pronounced for firms communicating complex information."[177]

491, 494 n.2 (2006) (citation omitted) (citing SEC. INDUS. ASS'N, COSTS AND BENEFITS OF REGULATION FAIR DISCLOSURE (2001)).

[175] *See* Zohar Goshen & Gideon Parchomovsky, *On Insider Trading, Markets, and "Negative" Property Rights in Information*, 87 VA. L. REV. 1229, 1268–69 (2001) (noting that, for smaller companies, the "cost of gathering and processing information to the market does not guarantee any individual analyst a sufficient return to justify the coverage. . . . [F]or small companies whose shares are traded with low liquidity, [temporary exclusivity] is a necessary step on the way to competitive analyst coverage. In this sense, the exclusivity generated by selective disclosure is analogous to that created by patent or copyright protection. In all cases, the loss associated with the grant of temporary exclusivity is presumably outweighed by the ensuing long-term benefits").

[176] Armando Gomes, Gary Gorton & Leonardo Madureira, *SEC Regulation Fair Disclosure, Information, and The Cost of Capital*, 13 J. CORP. FIN. 300, 301 (2007).

[177] *Id*. at 300.

To the extent that there ever was a need for a statutory regime of mandatory disclosure designed and enforced by the SEC, this need diminishes substantially as markets become more efficient. Any information that was supplied by the force of law now would instead be supplied by the markets. The SEC thus actively works to hinder the market's ability to create fair, efficient markets in order to maintain its own relevance.

The GameStop embroglio provides a vivid illustration of securities regulation in general, and the SEC in particular, being part of the problem rather than the solution. The solutions that the SEC would provide both hinder market efficiency and constrain market participation to a limited, elite few.[178] For instance, the SEC could consider curbing short selling. However, this would have a potentially devastating effect on market efficiency by eliminating the market's most direct and powerful device for identifying fraud and mispriced (overvalued) companies.[179] The SEC could also choose to curb retail trading by hunting down those who traded in GameStop shares and charging them with market manipulation. This second course of action is precisely what the SEC and other regulators appear to be doing today.[180] It is difficult to imagine that even the SEC would pursue a strategy of suing the very retail investors that they ostensibly are protecting. But stranger things have happened.

III. CONCLUSION

The GameStop story is, by now, the stuff of legend. But the story is well worth recounting. It is a tale of how common retail investors across the country rose up together and brought Andrew Left and his mighty hedge fund Melvin Capital to its

[178] On some solutions under consideration by the SEC, see Katanga Johnson, *U.S. SEC Chair Says Reviewing Short-Selling, Swap Rules After GameStop, Archegos Sagas*, YAHOO!: FIN. (May 5, 2021), https://finance.yahoo.com/news/u-sec-chief-plans-scrutinize-183900055.html [https://perma.cc/YG5H-39MN].

[179] *See supra* note 77 and accompanying text.

[180] *See supra* note 70 and accompanying text.

knees. The glitch in the story is that those who were shorting GameStop were not villains, because there is nothing villainous about shorting stock.

The only ethically problematic aspect of what the GameStop short sellers were doing was their apparent attempt to attract followers to their cause by publicizing their negative views about that company. This, of course, is no different than what those posting on Reddit were doing. If the retail traders are subjected to enforcement actions by regulators, then the hedge funds traders should be similarly pursued.

More broadly, the GameStop episode provides a valuable opportunity to reflect on the notion that securities regulation can promote the goals of achieving fair, orderly, and efficient capital markets. Markets are not, by nature, particularly fair and orderly. To a large extent, "fairness" in the context of investor protection in capital markets means that investors receive fair market value for the financial assets they buy and sell. As such, it is efficient markets, not regulation, that generate fairness for investors.

Unfortunately efficient markets are a threat to regulators because in efficient markets regulators simply are unnecessary.