

**Who's Liable After GameStop**  
**A Talk with Professor James Cox of Duke Law School**  
**And Kenneth Breen and Phara Guberman of Paul Hastings LLP**

- Overview of GameStop stock saga
  - On January 2021, shares of GameStop (GME) spiked, jumping nearly 1000% over the course of 2 weeks, amid volatile trading.
  - Spike was spurred largely by retail investors who took positions in the stock after chatter on the Reddit subreddit r/wallstreetbets. Some in the online community noticed that the stock was heavily shorted and believed it was undervalued. Online discussion triggered activity resulting in a short squeeze of GME and other stocks in similar positions.
  - As investors flooded the market, Robinhood, the commission-free trading app, restricted trading in GameStop and several other volatile stocks, including AMC (AMC) and BlackBerry (BB) for a day. Other trading platforms also followed. Robinhood, in a statement, said the restrictions were placed because of increased clearinghouse-mandated deposit requirements.<sup>1</sup>
  - Other players in the saga:
    - Hedge fund Melvin Capital which suffered huge losses as a result of the short squeeze
    - Citadel and Point72 asset management firms bailed out Melvin Capital with a \$3 billion loan as a result.
    - Citadel Securities, a division of Citadel that operates separately, profited from the rally as a market maker, executing orders from Robinhood.
- Clearinghouses and capital requirements
  - Clearinghouses are SEC-registered organizations that act as the central depository for securities. They keep a record of the stocks owned through a brokerage.
  - Clearinghouses establish financial requirements for members including deposit requirements designed to reduce risk to the clearinghouse.
  - During the GameStop saga, the amount required by clearinghouses to cover the settlement period of some securities rose tremendously, causing Robinhood to place restrictions in place on a small number of securities that the clearinghouses had raised their deposit requirements on, including GameStop<sup>2</sup>.
- Payment for order flows

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<sup>1</sup> Robinhood blog: What happened this week (Jan. 29, 2021):

<https://blog.robinhood.com/news/2021/1/29/what-happened-this-week>

<sup>2</sup> See Team, R. (2021, January 30). *What happened this week*. Under the Hood.

<https://blog.robinhood.com/news/2021/1/29/what-happened-this-week>.

- Commission-free brokerages like Robinhood generate revenue through payment for order flows, by directing trades to certain market makers with which they have prearranged agreements. Market makers compete for order flow and execute customer orders. They generate revenue through the difference in the bid-ask spread.
- SEC Rule 606 under the Regulation National Market System governs disclosures regarding payment for order flows.<sup>3</sup>
- Robinhood SEC settlement for omitting disclosure of payment for order flows revenue source<sup>4</sup>
  - On December 17, 2020, SEC charged Robinhood for failing to disclose payment for order flows and failing to satisfy its duty to seek best reasonably available terms to execute customer orders. Robinhood agreed to pay \$65 million in the settlement.
  - SEC findings against Robinhood:
    - Made misleading statements and omissions in its communications to customers. On its website FAQ pages, Robinhood did not disclose that its largest revenue source was for payment for order flow.
    - Received a substantially higher payment for order flow rates than other retail broker-dealers and did not conduct adequate reviews to ensure it was satisfying its best execution obligations.
    - Claimed that its “execution quality and speed matches or beats what’s found at other major brokerages.” But internal analysis showed that Robinhood provided inferior trade prices.
  - Robinhood agreed to:
    - Cease and desist from future violations
    - Censure
    - Pay \$65 million penalty
- Questions of market manipulation in the GameStop saga
  - Market manipulation statutory and case law standards vary.
  - Securities Exchange Act of 1934
    - §10(b): makes unlawful to “use or employ, in connection with the purchase or sale of any security” a “manipulative or deceptive device or contrivance.” 15 U.S.C. § 78j(b).
    - SEC Rule 10b-5: prohibits fraud, “untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading,” and deception. 17 C.F.R. § 240.10b-5.
    - §9(a)(2) scienter requirement: unlawful “to effect ... a series of transactions in any security registered ... creating actual or apparent

<sup>3</sup> SEC Release No. 34-84528, Disclosure of Order Handling Information, <https://www.sec.gov/rules/final/2018/34-84528.pdf>.

<sup>4</sup> In the *Matter of Robinhood Financial, LLC* Administrative Proceeding File No.: 3-20171, <https://www.sec.gov/litigation/admin/2020/33-10906.pdf>

- active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.” 15 U.S.C. § 78i(a)(2).
- *United States v. Royer*, 549 F.3d 886 (2d Cir. 2008)
    - Jeffery Royer and Anthony Elgindy were convicted in 2005 and sentenced for their roles in a securities fraud conspiracy. *U.S. v. Elgindy* (EDNY, 2005).
    - Royer, an FBI Special Agent, provided information about companies under FBI and SEC investigation to Elgindy who then traded on information to establish short positions in those companies’ stocks. Elgindy ran two websites in which he spread the misappropriated information to subscribers and readers.
    - The Second Circuit affirmed the convictions and sentences and noted on appeal that market manipulation encompasses not only materially false and misleading statements but also “constructive frauds” or acts which would “operate as a fraud or deceit upon any person.” 17 CFR § 240.10b-5(c).<sup>5</sup> Conduct itself can be deceptive.
  - Pump-and-dump schemes
    - Party acquires a position and spreads false or misleading information to artificially inflate the stock, then dumps shares at the inflated price. Requires statements that were false and material or made material omission with intent to manipulate, deceive, or defraud.
  - Evaluating subreddit wallstreetbets activities
    - Were there false or misleading information spread to boost stock prices that were material to the stock’s performance?
    - Was it a concerted effort or manipulate the market or a discussion of market views?
      - The truthfulness of the statements
      - Whether there are any misleading omissions
      - Whether the statement is material
  - Lawsuits against Robinhood related to the GameStop saga
    - Robinhood faces numerous lawsuits for its actions, including several class action suits around the country.
    - Class action suit filed in the Central District of California: motion for a temporary restraining order seeking to restrain and enjoin Robinhood from suspending buying on its app. The suit makes four claims against Robinhood: 1) violation of Section 9(a)(2) of the Securities Exchange Act; (2) violation of the Computer Fraud and Abuse Act (“CFAA”), 18 U.S.C.A. § 1030; (3) violation of California’s Business and Professions Code § 17200 (“UCL”); and

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<sup>5</sup> 17 CFR § 240.10b-5(c), [https://www.govregs.com/regulations/expand/title17\\_chapterII-i1\\_part240\\_subpartA\\_subjgrp68\\_section240.10A-3#regulation\\_9\\_0](https://www.govregs.com/regulations/expand/title17_chapterII-i1_part240_subpartA_subjgrp68_section240.10A-3#regulation_9_0).

- (4) negligence. The court issued a tentative ruling prior to hearing denying the motion.<sup>6</sup>
- Class action suit filed in the Southern District of New York: complainants accuse Robinhood of “purposefully and knowingly” restricting trading to manipulate the market. Complaint claims breach of contract and implied covenant of good faith and fair dealing.<sup>7</sup>
  - Breach of contract claims
    - Robinhood Customer Agreement provides:<sup>8</sup>
      - Trade restrictions at its discretion, including restricting access to its app or website, refuse transaction, refuse executions, or terminate account.
      - Account termination right at its sole discretion.
  - Other claims include breach of implied duty of good faith and fair dealing, negligence, and breach of fiduciary duty.
- Financial Industry Regulatory Authority (FINRA) rules on communications
    - Keith Gill, an investor who shared his view that GameStop was undervalued to the subreddit wallstreetbets, was a registered representative of MML Investors Services, a broker-dealer based in Massachusetts, at the time of the GameStop saga. He and his former employer may face FINRA scrutiny.
    - Gill may face inquiry into his social media use (FINRA Rule 2210)<sup>9</sup>, whether he sought and received permission to open a trading account at another firm (FINRA Rule 3210)<sup>10</sup>, whether he filed incomplete or misleading information in his registration (FINRA Rule 1122)<sup>11</sup>, and other activities.

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<sup>6</sup> *Levi Cobos v. Robinhood Financial LLC et al.*, Case No. 2:21-cv-00843, <https://www.courtlistener.com/recap/gov.uscourts.cacd.808873/gov.uscourts.cacd.808873.30.0.pdf>.

<sup>7</sup> *Nelson v. Robinhood Financial LLC, et al.*, Case No. 1:21-cv-00777, [https://www.sdnblog.com/files/2021/02/complaint\\_2.pdf](https://www.sdnblog.com/files/2021/02/complaint_2.pdf).

<sup>8</sup> Robinhood Customer Agreement, <https://cdn.robinhood.com/assets/robinhood/legal/Robinhood%20Customer%20Agreement.pdf>.

<sup>9</sup> FINRA Rule 2210, Communications with the Public, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/2210>.

<sup>10</sup> FINRA Rule 3210, Accounts At Other Broker-Dealers and Financial Institutions, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/3210>.

<sup>11</sup> FINRA Rule 1122, Filing of Misleading Information as to Membership or Registration, <https://www.finra.org/rules-guidance/rulebooks/finra-rules/1122>.