Some new light shed on GameStop frenzy

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A congressional hearing held last Thursday into the GameStop share trading frenzy cast some light, albeit limited, on previously little reported but significant practices in the operations of Wall Street.

The inquiry by the House Financial Services Committee involved questioning of those associated with the GameStop market surge last month, which involved a "short squeeze" on hedge funds, most notably Melvin Capital, which had shorted the stock.

Shorting involves borrowing the shares of a company and then selling them with the aim of forcing down the price, whereupon the seller buys the shares at the lower price and returns them to the lender, making a profit on the transaction.

GameStop was a target of the squeeze because it had been heavily sold by short sellers, to the extent that some 140 percent of its shares were the subject of short trades. In other words, some shares had been borrowed more than once in the shorting operation.

Retail investors, using the share-buying app Robinhood and postings in a Reddit app boosting GameStop buying, began a frenzy of buying, forcing up the price—from $19 at the start of the year to more than $330, an increase of 1,500 percent. The operation depended on forcing the short sellers to start buying in order to cover their trades, leading to a loss of $3 billion by Melvin.

But it came to a sudden conclusion when Robinhood suspended purchases of GameStop shares and a number of other shorted stocks, and the price came tumbling down, leading to major losses, sometimes running into the hundreds of thousands of dollars, for relatively small investors. Some of them had borrowed heavily, even taking out mortgages, to get into the speculation in the hope they could make a fortune overnight.

The scheme had been accompanied by claims, circulated on Reddit and on other social media outlets, that the GameStop "short squeeze" was a means for "democratizing finance." The claim was that it involved taking on the big hedge funds and was a means of beating Wall Street at its own game.

But on January 28, Robinhood suspended trading because it did not have sufficient capital lodged with its clearing house to cover its operations.

During his testimony to the House committee, Robinhood chief Vlad Tenev admitted for the first time that his firm had not been able to meet a capital call of $3 billion from the National Securities Clearing Corporation in the early hours of the morning. These payments are required to cover any potential shortfalls between the time a buyer places an order for shares and the final settlement.

Previously, Tenev had told the business channel CNBC: "There was no liquidity problem, and to be clear, this was done preemptively."

However, in response to questioning, Tenev admitted: "At that moment we would not have been able to post the $3 billion in collateral."

In response to the assertion by Anthony Gonzales, a Republican committee member from Ohio, that the "multiple" claims his firm did not have a liquidity problem were "not necessarily true," Tenev replied: "The Robinhood team had to work with our relevant clearing houses to adjust the risk profile of the trading day in order to meet our collateral requirements."

He said that if Robinhood had not been able to meet the call from its clearing house, it would have resulted in "a total lack of access to the markets" for our clients.

Apart from revealing what happened on January 28 and exposing the attempted cover-up by Tenev and Robinhood, the hearing also revealed some details about its modus operandi, which is assuming greater significance in the market as a whole.

Robinhood proved very attractive to small investors because it did not charge a commission on share trading like that imposed by major brokerages.

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The company was able to do this because of the practice of payment for order flow (PFOF). Under this scheme, Robinhood made money by collecting a fee by passing on its orders to large Wall Street trading firms to execute them. The trading firm makes money by securing a better price in the market for the transaction, either buying or selling, than the initial asking price, using the profit to make payments to the brokerage firm and pocketing the rest.

The PFOF mechanism was first developed by the notorious Ponzi scheme operator Bernie Madoff. It has been all but banned in other jurisdictions, including the UK, but has assumed increasing importance on Wall Street, as speculation has reached ever greater heights.

According to an article in the *Financial Times* earlier this month, monthly filings collated by Bloomberg show that “payment for order flow” generated $2.9 billion for US brokers in 2020, with TD Ameritrade picking up $1.1 billion in fees and Robinhood collecting almost $700 million.

As the *Financial Times* reported: “The market makers, which use computing power to execute trades at extraordinary speed, have elbowed traditional investment banks out of the market. They now sit on one side of more than three out of every ten trades that take place outside traditional exchanges, according to the Financial Industry Regulatory Authority.”

The newspaper went on to note that the proponents of PFOF maintain that it creates “an incentive to draw buyers and sellers into the market and provides a better deal for investors than they would get on an exchange such as those operated by Nasdaq and New York Stock Exchange.”

The real nature of this drawing in operation was alluded to in an observation by Illinois Democratic Representative Sean Casten on Robinhood’s method of operation.

“There is an innate tension in your business model between democratizing finance, which is a noble calling, and being a conduit to feed fish to the sharks,” he said.

The experience of the GameStop frenzy demonstrates that the “democratizing of finance” mantra promoted by various right-wing libertarian groups and individuals, far from being a “noble calling,” played a key role in moving large schools of small fish into the orbit of the financial sharks.

It should always be remembered that trading on the stock market is a zero-sum game. That is, the losses incurred by small GameStop investors, probably running into many millions of dollars, have been pocketed by some of the most powerful sections of the financial oligarchy.

And the GameStop frenzy has a broader significance. The history of financial manias reveals that crashes are almost invariably preceded by a situation in which small investors are drawn in, lured by the prospect of rapid enrichment, accompanied by slogans such as “this time it’s different,” or, in this case, that finance is being “democratized” and that the Wall Street titans are being beaten at their own game.

The whole experience is another salutary lesson that the only viable perspective is not to “occupy Wall Street,” or attempt to “democratize” or regulate it, but to end its domination over the fate of billions of people by removing the financial oligarchy it serves by means of a mass movement of the working class fighting for socialism.

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