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Game On: GameStop, Market Manipulation, and Its Implications

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Game On: GameStop, Market Manipulation, and Its Implications

By: Travis Strickler, Staff Editor, Vol. 110



The meme-stock phenomenon that took investment markets by storm in early 2021 created chaos for both investors and regulators. Individual investors—led by the subgroup “WallStreetBets” on Reddit.com—collaborated to increase the stock prices of certain companies through a coordinated effort to purchase the stocks and generate losses for hedge funds who took opposing positions.[1]

The pandemonium peaked in late January when GameStop’s (GME) stock price – which became the rallying point of the meme-stock movement – skyrocketed from \$20 to \$438 over a two-week period.[2] This prompted investigations by numerous government entities, a congressional hearing, and the controversial decision by brokerage platforms to restrict trades on the stock.[3] These events empowered investors who voiced their intentions on online forums to stymie large institutional investors by sending GME’s stock price “to the moon,” but also raised concerns over possible market manipulation.[4] Questions remain regarding the legality of the individual investors’ actions and whether this type of coordinated exploitation can continue.

Potential Claims Against Investors

Price manipulation is governed by Section 9(a)(2) of the Securities Exchange Act of 1934, which defines manipulation as a series of transactions to induce the purchase or sale of a security by others.[5] The SEC, however, does not typically pursue violations under this section, and instead opts to prosecute manipulation claims under Section 10(b) and Rule 10b-5.[6]

The SEC promulgated Rule 10b-5 to prohibit manipulative trading practices, including schemes to defraud, disseminate false statements of material fact, and engage in deceptive practices with securities trading.[7] A claim under Rule 10b-5 must show the defendant: (1) made a material misstatement, omission, or used a fraudulent device pertaining to the sale or purchase of a security (2) with intent to deceive, manipulate, or defraud, and (3) the plaintiff relied on this misrepresentation to their detriment.[8] Market manipulation also requires the creation of artificial demand for the security that synthetically influences market activity and misleads investors.[9]

Did Individual Investors Engage in Market Manipulation?

The Exchange Act seeks to protect individuals from nefarious acts by institutional investors, but ironically the GME phenomenon involved individuals engaging in alleged manipulative activities at the expense of institutions.[10] This poses the interesting question of whether the legislation enacted to safeguard individual investors can be used against them to benefit large financial institutions.[11]

Claims under Rule 10b-5 require an allegation of scienter, which encompasses the intent to deceive, manipulate, or defraud.[12] Unfortunately for regulators, the SEC's broad and intent-centric approach to market manipulation fails to create a consistent basis for liability and makes enforcing these provisions difficult.[13]

Here, investors' actions undoubtedly drove up the GME's stock price, but there is no evidence this occurred through spreading false information or other perverse trading tactics.[14] On the contrary, investors proudly posted their intentions on online platforms and encouraged others to participate,[15] which is categorically different from the traditional tools of artificial demand such as wash sales, matched orders, or rigged prices.[16] These statements were not fraudulent, but instead focused on damaging the institutions who bet against GME.[17] Experts are citing "irrational exuberance"—not misrepresentation or deception—as the source of the trading frenzy.[18]

Additionally, some investors continue to hold their GME positions, which contradicts the norm in typical "pump and dump" schemes.[19] Therefore, these individuals lack the requisite intent and fraudulent behavior to pursue charges of market manipulation under Rule 10b-5.[20]

Conclusion

The vague standards of Section 10 and Rule 10b-5 coupled with the arduous task of proving the malicious intent of individual investors makes a potential market manipulation case against GME investors unlikely to succeed.[21] Unless the SEC deviates from its intent-focused approach and provides clearer guidance on the enforcement of market manipulation, individual investors may continue to voice their activism through the securities markets, which could have a drastic impact on the future of our financial system.

[1] Joshua F. Bartz, *What Is the SEC Going to Do About GameStop?*, N.Y. State Bar Ass'n (Feb. 2, 2021), <https://nysba.org/what-is-the-sec-going-to-do-about-gamestop/> (<https://nysba.org/what-is-the-sec-going-to-do-about-gamestop/>).

[2] Dave Michaels, *GameStop Mania Is Focus of Federal Probes Into Possible Manipulation*, Wall Street Journal (Feb. 11, 2021, 7:50 PM), https://www.wsj.com/articles/gamestop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950?mod=searchresults_pos20&page=19 (https://www.wsj.com/articles/gamestop-mania-is-focus-of-federal-probes-into-possible-manipulation-11613066950?mod=searchresults_pos20&page=19).

[3] Bartz, *supra* note 1.

[4] Dave Michaels & Alexander Osipovich, *GameStop Stock Surge Tests Scope of SEC's Manipulation Rules*, Wall Street Journal (Jan. 28, 2021 7:49 AM) <https://www.wsj.com/articles/gamestop-surge-tests-scope-of-secs-manipulation-rules-11611838175> (<https://www.wsj.com/articles/gamestop-surge-tests-scope-of-secs-manipulation-rules-11611838175>).

[5] 15 U.S.C.A. § 78i(a)(2).

[6] Gina-Gail S. Fletcher, *Legitimate Yet Manipulative: The Conundrum of Open Market Manipulation*, 68 Duke L.J. 479, 500.

[7] 15 U.S.C.A. § 78j(a)-(c).

[8] Fletcher, *supra* note 6, at 498. See also *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 197 (1976).

[9] Michaels, *supra* note 4; see also Bartz, *supra* note 1 (stating the intent required in scienter also implies intent to create an artificial demand for the stock).

[10] Aaron Keller, *SEC Will Struggle to Build Market Manipulation Case After Massive GameStop Rally: Securities Law Professor*, Law and Crime (Jan. 30, 2021, 8:05 PM) <https://lawandcrime.com/high-profile/sec-will-struggle-to-build-market-manipulation-case-after-massive-gamestop-stock-rally-securities-law-prof/> (<https://lawandcrime.com/high-profile/sec-will-struggle-to-build-market-manipulation-case-after-massive-gamestop-stock-rally-securities-law-prof/>).

[11] *Id.*

[12] Ernst & Ernst, *supra* note 8, at 193.

[13] Fletcher, *supra* note 6, at 486.

[14] Michaels & Osipovich, *supra* note 4; see also Keller, *supra* note 10.

[15] Michaels, *supra* note 3.

[16] See Bartz, *supra* note 1 (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977)).

[17] *Id.*

[18] Keller, *supra* note 10.

[19] *Gamestopped* (Hulu 2021).

[20] Michaels, *supra* note 3.

[21] See Fletcher, *supra* note 6, at 494.

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