GameStop Tumult Puts Hedge Fund Industry in the Spotlight

by Kevin J. O'Brien / December 8, 2021

The buying frenzy in GameStop Corp. stock, which began late last month and saw the price rise as much as 1,700% as amateur traders using an online trading platform egged one another on, is apparently over (for now). Even with a slight bump up last Friday, the stock fell about 80% last week, to the distress of many latecomers.

Whether the manic trading was the first stirring of a populist revolt, akin to the demonstrations that have lately rocked our political world, or more simply a pump and dump scheme, is a matter of debate. Either way, the GameStop furor has focused attention on hedge funds, a thinly regulated industry that for all its Midas-like success is rarely in the spotlight. Government scrutiny is sure to follow.

To be sure, large hedge funds that shorted GameStop were the principal victims of the stock runup, caught in a squeeze that cost them billions of dollars. Yet the funds were not merely victims. For one, large players were on both sides of GameStop stock. Senvest Management, for example, now a $2.4 million hedge fund, made $700 million during the stock runup. Other hedge funds were positioned to profit in other ways. Several weeks ago, the large hedge fund Citadel participated (along with Steve Cohen's Point 72 Asset Management) in a $2.75 billion dollar emergency cash infusion into Melvin Capital Management, a short seller facing huge losses because of the GameStop rally. Citadel is an affiliate of Citadel Securities, the largest market maker for retail stock-trading in the country, which handles as much as 30% of GameStop's order flow. In other words, Citadel was propping up a fund that had shorted GameStop stock, while Citadel Securities was profiting from the bullish retail bets that drove up the stock.

None of these relationships suggests wrongdoing, but they are bound to attract the attention of regulators already smarting from the perception that they should have done more to protect investors in the GameStop trading frenzy. Particularly controversial was the January 28th decision of Robinhood Markets and other online trading platforms to suspend buys, but not sales, of GameStop stock. This action, widely criticized as protective of the short sellers, was triggered by increased collateral requirements imposed on brokerages by the Depository Trust & Clearing Corp. (DTCC), in response to the growing volatility of GameStop and other stocks. The restrictions on online buying were lifted the next day, but not before the SEC publicly announced it would "closely review actions taken by regulated entities that may disadvantage investors or otherwise unduly inhibit their ability to trade certain securities." The SEC's vow was a response of sorts to a January 29th letter from Senator Elizabeth Warren, who complained of the "casino-like swings" in GameStop and other companies, and demanded that the SEC "act to ensure that markets reflect real value, rather than the highly leveraged bets of wealthy traders or those who seek to inflict financial damage on those traders."

All of this suggests that hedge funds, a convenient target at a time of unusual turmoil in the retail markets, can expect more scrutiny – from press, regulators, and enforcement officials – than they

have usually received, not just as to their core trading operations but their other business relationships as well.