A Positive GameStop Fix

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Summary

- The GameStop Kamikaze Movement may be accommodated by adding a trading facility to a host futures market.
- The article explains why a lasting accommodation to the GameStop Kamikaze Movement is necessary and desirable.
- It then provides a description of an appropriate trading facility.

Source: GoGraph

A Preface. Finance is a positive, not a normative science. In my book, hedge funds simply are. The GameStop (NYSE:GME) Kamikazes are. Neither bad nor good. Here I define them – not judge them.

This article seeks to help make the investment ride safe for all in the presence of the relatively new role, or at least newly prominent role, of social media-driven retail trading. Paul Rowady provides the GameStop Kamikaze moniker. The link is to his excellent summary of the GameStop phenomenon.
Who are the GameStop Kamikazes?

According to Campbell Harvey at Duke, “The crowd acts as a decentralized hedge fund. Through their forums, they exert the power of a large institutional investor.” Read his remarks here.

This GameStop Herd phenom (GH) is not an investment in the usual sense. That is, nobody buys the stock because of the future bounty of dividends that the stock will produce. The moniker of the Reddit chatroom GH frequents, WallStreetBets, says it all.

GH is closer in spirit to Bitcoin than to a value-seeking investment. Bitcoin is a system for electronic transactions that does not rely on user trust (in the government or a corporation). The Bitcoin system is a computer program. No people involved. Bitcoin was once touted by advocates as a currency protected from government-created inflation, but the volatility of bitcoin has eliminated that argument.

GameStop was chosen by GH. The GH phenomenon is part of a larger rebellion by retail investors against their supposed enemies on Wall Street. Hedge funds that specialize in shorting dubious investments like GameStop (The Shorts). Are viewed as the enemy. In this morality story, Elon Musk is the folk hero.

The Redditors are using the theory of the “greater fool” or “pump and dump.” They choose a company that is popular with The Shorts, then buy the stock in concert, hoping to pick the highest value it reaches before returning to the bleak reality.

How do we better manage freedom of asset choice?

How can the GH phenom be managed in such a way that the bets GH are accommodated with a minimum of risk to the financial system? I suggest that a facility be authorized by the CFTC, or the SEC if more desirable, for overnight approval of a “futurized” version of the GH stock to be listed on a futures trading venue. By “futurized” I mean the adaptation of futures trading technology to the trading of common shares in GameStop-like situations.

The exchange proposing such a facility would have the futurized trading system in place in advance of listing, needing only the stock ticker to open trading. If approved, I have no doubt the futures exchanges would happily introduce such a facility.

Why futurization?

It is a well-understood reality that instruments with volatile prices and rapid surges in trading volume are more safely traded using the trading technology of futures markets, while the day-to-day trading of individual corporate issues for investment purposes is better handled on a stock exchange where
transfer and clearing of ownership through Depository Trust and Clearing Corporation (DTCC) is a routine, but costly (and unnecessary for GH) part of every transaction.

Bitcoin futures are a recent example of a futures listing in a highly volatile price index that was readily adapted to futures trading. While spot bitcoin exchanges like Binance regularly run into times of “stress” when trading is temporarily suspended, read here — the futures version traded on CME has no such problems.

**Why is GameStop not a “pump and dump” situation?**

The anti-Wall Street, anti-hedge fund, anti-short seller passion has grown into a movement. GameStop trading is part of that movement. No reasonably well-informed retail investor believes the changes in the GameStop stock valuation were inspired by equal changes in investors’ expected payments of dividends. There is a clear understanding that the GameStop trade is part of a war of wills between buyer and seller. But unlike a pump and dump operation and more like the bitcoin movement, there is no reason to assume that GameStop will ever trade down to its pre-GH depth.

After all, the world has no shortage of other assets that do not have value based on expected dividends, or tangible assets, or other market fundamentals. Financial instruments as fundamental as fiat currencies have value solely because their owners believe in them.

More recently bitcoin, a computer program – no humans involved, no assets at all, no possibility of government regulation. Not only do governments not regulate bitcoin, but they have tried and found it impossible. Wow! What a concept! Next to bitcoin, the GameStop phenomenon seems very tame to me.

**A close cousin to futurization of the GH phenom**

One admittedly less controversial relative of GH futurization is Small Exchange. An objective of a futurized GH is easier retail access and lower cost retail trading. Small Exchange was created expressly to provide retail access to existing financial futures that are elsewhere dominated by wholesale traders. Small Exchange reduces the size of a transaction to about 10% that of the dominant contracts offered by CME Group. It also assures the user of an easily understood way of finding the value of the instruments (common stock indexes like one based on the value of the S&P 500 stock index, another based on dollar interest rates, and a gold price index contract). The Small Exchange probably will not futurize GameStop or the like since there is no way to form an index on an individual stock.
Hence the need to call the new instrument futurized GH, not GH futures.

Mechanics of futurization

GH futurization must solve the following problems:

1. Reduce the capital absorbed. The big issue with current GH trading is the sudden demands it places on the capital of brokers, exchanges, and DTCC.

2. Minimize the effect on the positive-sum game part of the equity market.

3. Make trading both short and long positions equally costly and equally simple.

Margin requirements. A futurized GH would have the smaller margin requirements consistent with futures trading. The advantages for retail GH traders of a futures-like margin are explained on the Small Exchange website. The three primary advantages:

- Smaller than stock margins
- Risk-based and adjustable.
- The same for buyers and sellers.

This would be a major reduction in the capital requirements met by the broker. The retail brokers make the claim that they “cannot afford” to add the necessary capital to pay up their required capital in support of unfettered retail trading. Do not believe it. They do not want to share with other Wall Street investors the incredible profits that they will be reaping from the GH phenom.

Securities clearing costs. Futurized GH markets would eliminate direct clearing costs unless some wayward member of GH wants to take possession. Otherwise, the clearing cost would be absorbed by an Exchange investment manager (at a profit to the exchange). The entire GH market would be cleared through a single daily transaction.

- Less systemic risk than stock transactions
- Less costly
- Faster execution

Conclusion

These GH facilities, once approved by the regulators, could be opened with the flip of a switch. I have a strong opinion that this is the future for the Exchange Clearing House (ECHO) market.
developed a generic financial instrument – the Exchange Originated Instrument (EOI) – and a joint cash and futures traded market – Self Settling Futures (SSF), explained here. The futurized GH would be an example of the application of these inventions.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Comments (18)

Dan Stringer  
Contributor  Premium  
Comments (2.31K)

Thanks for the article. Essentially shares could trade on a blockchain like Bitcoin does currently, though probably more similar to Ethereum since there could be added shares available or removed.

@Dan Stringer Author's Reply Unnecessarily slow and expensive. We need a faster easier way to trade.

Kurt Dew  
Contributor  Premium  
Comments (1.42K)

@Dan Stringer Good point but would eliminate the central clearing house. Speed for decentralization.

Dan Stringer  
Contributor  Premium  
Comments (2.31K)
**Kurt Dew**  
*Contributor  Premium*  
Comments (1.42K)

**Author's Reply @Dan Stringer.** The clearing function is already eliminated. The exchange clears itself. All transactions directly involving ordinary shares would be between the exchange investment fund and, most likely, an HFT. Alternatively, the exchange might seek, or might already have, clearing member status at one of the major stock exchanges. The possible colocation of two transaction platforms is enticing.

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**57seagull**  
*Marketplace  Premium*  
Comments (801)

Thanks for the thought-provoking article. If there were no shorting allowed, this GME short squeeze problem would not exist.

If there were reasonable shorting limitations and effective regulatory enforcement, this short squeeze problem might not have occurred. Even if shorting is allowed, should it be eliminated or substantially limited in times of crisis or economic turmoil such as bank failures, pandemics, war, or other major calamities or emergencies? Both GME and AMC have been impacted by the virus which kept most of their potential customers at home.

I recall news reports suggesting that Melvin Capital, for example, had substantial margin loan exposure which also affects its brokers and lenders, particularly with the unlimited risk exposure of some short investments. Should margin lending for short investments be substantially limited? Further, this margin loan availability enables hedge fund shorts to have massive and disproportionate impacts on the stocks they are shorting. Hedge funds should be limited to using their own assets for short purposes.

Additionally, news reports have indicated that 140% of the GME float was short. With naked shorting supposedly prohibited, how was that possible? There should be appropriate investigations by regulators with strong penalties for any naked short selling revealed.

🔗 Reply  🔄 Like

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**Kurt Dew**  
*Contributor  Premium*  
Comments (1.42K)

**Author's Reply @57seagull,** retail traders should celebrate shorting! Without the Short Funds, there would be nobody to vilify. It will soon occur to the WallStreetBets community that a herd can make money shorting a stock. They will also learn that is more expensive for them to short than it is for hedge funds. There should be routine access to shorting for WSBers.

I sense a moral objection to shorting that I don't share.

Regards, Kurt
Patrick Doyle

@Kurt dew

Many thanks for the article.

For the life of me, though, I'm still trying to work out why the GME phenomenon is framed as a problem?

It's certainly a problem for shorts, but those shorts are smart enough to demand extra risk adjusted compensation for any of their future shorts. They know that they're about as popular as syphilis, and that if they do something stupid like short more than 100% of the shares of a company they may run into trouble. This whole episode could be a so-called "learning moment" for the naked emperors of Wall Street.

It certainly should be a problem (let's see if it will be) for brokers who lent way too many shares to shorts. It's been a while since I had to write my ethics exam, but if memory serves, the regulators take a dim view of naked shorting...

Markets adapt, and markets have to now adapt to the fact that there's a new player in town, this decentralized hive of small retail who will act in non predictable ways. As you say, these people aren't acting like rational investors. They're attacking people who have benefitted from a broken market for years now.

You don't judge. I obviously do. I'd be lying, if I didn't admit to finding it very, very entertaining that Wall Street idiots are being pulverized by a bunch of teengage kids who call stocks "stonks."

I'm also wondering if some of the idiots are tone deaf enough to ask for help from the public purse again.

Thanks again for the article and enjoy your day.

PD

kbaba

@Patrick Doyle The whole phenomena, applied to a host of stocks with over 40% short interest, could well bring down the whole financial system like a house of cards.

Kurt Dew

Author's Reply @Patrick Doyle The problem was that investors could not buy the GME shares they wanted to buy.

I do believe the retail broker's explanation for the failure to execute "We can't afford it" is lame. There
would be no shortage of interest if the brokers sought an equity infusion.  
If they ask for government help, they won't receive it.  

Regards, Kurt

Author's Reply @kbaba. That is the risk. The point of GH futurization is to minimize this risk. The plan would put the trade in a safer environment -- and would make access to the trade a level playing field. 

Regards, Kurt

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