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By Nicholas Blank

The “Robinhood Effect” on Due Diligence

Until recently, many Wall Street professionals viewed individual retail investors as minor players in the equity market with little power to drive share prices. That assumption was finally put to bed by the astonishing surge (and subsequent crash) of once sleepy stocks such as those of GameStop, AMC Theaters, and BlackBerry. These market movements were driven by coordinated—if leaderless—small-scale trades plotted on online message boards such as Reddit’s “r/wallstreetbets” and executed on zero-commission platforms intended for amateur investors, most notably offered by fintech startup Robinhood.

Robinhood’s user-friendly app, and other trading platforms such as eToro, have been credited with bringing millions of new investors into the market, creating emerging market pressures and volatility. The younger investors using these platforms have not followed their parents’ example of long-term investment in professionally managed mutual funds, opting instead to speedily take positions in individual stocks and exit just as quickly. This new generation of day-traders has responded enthusiastically to Robinhood’s mission statements that the wealth of financial markets should not be limited to financial professionals—or the privileged few who can afford their services.

Although the short-squeeze Reddit users put on GameStop may have been a misadventure aimed at creating market turbulence, much of the trading seen on Robinhood and other apps is in fact fueled by a wealth of data and amateur tips that once were out of reach for mom-and-pop investors. A visit to r/wallstreetbets gives a sense of the intensity and character of the information now driving retail investing: the message board is chock full of banter about hot trades, screenshots of online brokerage accounts whose anonymous owners purport to have made millions from flipping their favorite stocks, and the occasional punter who relishes sharing posts about losing substantial sums on trades, perhaps seeking some form of personal notoriety. Such peer-driven investment, in which individuals observe and emulate the trading behavior of their online interlocutors, has been termed “social trading.”

Reddit is hardly alone in fueling the “Robinhood effect” on the market. The resources available to the layman now are virtually endless relative to even a decade ago: Yahoo Finance, interactive stock charts, and stock pick email newsletters are just a few of the information streams the ordinary day-trader can draw on in making investment decisions. And if all that weren’t sufficient for retail investors, the revolution in finance has also produced an army of influencers who populate social media platforms and offer insights on Wall Street (often prefaced with the disclaimer "this is not financial advice"). These include people such as a 22-year-old who took leave from college last May to focus on offering investment advice and explainers to his two hundred thousand TikTok followers.

Investigators tasked with unearthing fraud and other undisclosed risks pertaining to listed companies and securities traders will need to adapt to this new environment. Investigative diligence into public companies must now include monitoring and analysis of the voluminous amount of data produced in social trading and messaging platforms, in addition to the traditional analysis of companies (such as reading annual reports, analyzing publicly disclosed financial statements, and reviewing regulatory filings). Investigators who handle in-depth research on companies already utilize dozens of databases and information sources to sift through public information that shed light on any number of issues (*e.g.*, litigation, fraud, FCPA compliance, cyber theft) that have material bearing on company valuations. Advances in specialized software to map social media sites and users will allow investigators to process data from the likes of Reddit on an unprecedented scale and speed, a critical factor given that traders with mobile apps watching YouTube videos can literally move billions of dollars in seconds.

These changes in investigative diligence, although accelerated by the GameStop experience, began earlier. Whether in the context of pre-investment due diligence, understanding allegations made by shortsellers against listed companies, or even obtaining intelligence on purported misconduct within listed companies, thorough investigators have incorporated research of relevant social media sites and trading forums, "influencers," and discussion boards into their methodology.

We have already seen the value of implementing these research strategies for clients, including hedge funds and publicly traded companies. One such client, the board of a large corporation in a proxy contest, sought information on its adversary, a group of activist investors with a mysterious source of funding. Our investigators noticed that past investments made by the activists in other listed companies closely mirrored another much larger investment fund with a checkered reputation. Turning to social media, we found message boards were rife with speculation about a potential nexus between the two investor groups. Knowledge of this relationship allowed investigators to focus inquiries in several emerging market economies where the investors were known to park funds. Links were soon discovered between the activists' funds, dodgy transactions, and potential corruption in those jurisdictions.

Time will tell whether the GameStop saga, like that of Hertz before it, will be a one-off troubling deviation from normal market behavior, or the hallmark of an unpredictable brave new world of financial democratization. Nevertheless, it is clear that having the right expertise and technologies will be essential to assess risks when investing in a world in which vital information has increasingly become available to the masses.

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