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The Modern World of Finance: How Social Media Has Changed Investing & How Audit Can Help

Abstract

The modernization of finance through fintech has brought with it a wave of new investors looking to capitalize on commission-free trading made easy by platforms such as Robinhood. However, this new investor base is consistently choosing to utilize social media as its information source instead of vetted financial documents. By using social media in such a manner, novice investors open themselves up to more information risk, or the risk that their collected information is misleading or false. The purpose of this research project is to analyze how the audit industry, which has historically been the main defense against sources of information risk, can evolve to lend credibility and context to information being circulated via social media and protect the modern investor base. I hope to accomplish this goal by analyzing current research on trading psychology, current audit practices, and current social media content regulation practices.

Introduction & Related Works

My first accounting professor, Anthony Menendez, told me that audit is unique because it is the only job where a professional's duty is not to their direct client. I do not know if audit truly is the only profession like this; however, I do know that it is very special for its responsibility to protect investors and their trust in the market. Audit in America began materializing after the

Great Depression destroyed people's confidence in the market. The Securities Acts of 1933 and 1934 established the SEC, or Securities Exchange Commission, and represent a major turning point in US corporate and market practices (Levy). The SEC is the major governing body for all market activities and sets the standards for all US companies; they also set up GAAP standards, or the Generally Accepted Accounting Principles.

From 1934 until the turn of the century the SEC refined its practices and maintained a fairly regulated market. However, 2001 brought with it the Enron scandal in which Enron, one of the largest US public companies at the time, doctored its books to calm investors' worries. The scandal resulted in one of the largest bankruptcy cases in US history and the dissolution of one of the largest accounting and auditing firms at the time. The SEC passed the Sarbanes-Oxley Act of 2002 (SOX) in order to establish new regulations as well as a governing body for auditors, the Public Company Accounting Oversight Board (PCAOB). From 2001 to 2021 not too much has changed within the audit world. Overall, the major frameworks of the audit profession come from the Securities Acts of 1933 and 1934, the establishment of GAAP, and the Sarbanes-Oxley Act of 2001 (Levy).

The entire evolution of the audit profession revolves around protecting investors and eliminating as much information risk as possible. Information risk in this context is simply false or misleading information that can affect an investor's decisions. Audit's main concern is maintaining investors' trust in the stock market, which is achieved by providing them with vetted and verified information. Today, audit is still focused only on public disclosures; however, as new investors start trading, the main source of information risk has increasingly become social media.

Robinhood is one of the most popular modern trading platforms; however, the gamified appearance which makes it so attractive to new investors has also led its novice users to exhibit riskier trading behavior (Tan 1873-1875). Bloomberg, a global leader in business and financial data as well as one of the most popular business media sources, says that Robinhood changed the trading landscape in four important ways. First and foremost it popularized commission free trading. It also popularized fractional share trading, started a new generation of fintech, and perhaps most importantly for this study it "helped make risky trading mainstream" (Massa). In addition to promoting riskier trades, Robinhood promotes herd behavior on its app by publicizing its "Top Movers" and "Most Popular" stocks (Nijboer 5-30). Robinhood has so much potential to do good; it has largely democratized and popularized finance and fintech. However, it has historically let its users bite the bullet of a plummeting portfolio after prompting them to follow risky trends and make riskier trades.

Social media has further compounded the issues of uninformed trading and herd behavior. A great example of this is the Gamestop(GME) short squeeze that occurred in January of 2021. A short is essentially betting on a stock price to fall by selling at current price from borrowed capital then buying at a lower price, thereby profiting the difference. A short squeeze occurs when the price of that stock bumps up so that investors who shorted have to buy stock in order to minimize losses, which in turn increases the price even more. The GME short squeeze was started by reddit group r/WallStreetBets; however, the movement quickly spread with the help of influencers such as Elon Musk. There was a sharp increase in the GME stock price after Elon tweeted the word "Gamestonk" with an embedded link to WallStreetBets (La Monica). The GME short squeeze lost hedge funds billions and proved that in the modern age of social media, retail investors can band together on sites such as “Reddit, and they can move the market as well as huge investment funds” (Lucangeli 15-22).

Although the GME case worked out in the favor of the retail traders, that is an exception to the usual case where hedge funds bleed retail traders dry. Dr. Persian Jiao of Maastricht University found that “coverage by social media predicts increases in volatility and turnover” of a stock; however, the information being propagated throughout social media is often stale and perpetuated by “echo chambers” (63). In other words, social media leads retail investors into poor trades by providing them with old information already capitalized on by hedge funds and other large scale trading entities. This issue is perhaps summarized best by Dr. Brad Barber, a world renowned authority on online investing and trader psychology, who stated in one of his most recent research papers that “retail investors may make wealth reducing trades because they do not realize that they are at an informational disadvantage” (18).

Investing has never been so democratized and widely available, but new investors are continuously utilizing information from social media rather than financial documents to determine their trades. This means that, on average, they lose money in the stock market. So, my question is: what is the best way audit can help mitigate social media related information risk? The big four accounting firms: Deloitte, KPMG, PWC, & EY, have historically been the front line defense against information risk, but they have not adopted any new programs to combat social media related information risk. While there are censorship strategies in place on platforms such as Facebook, Twitter, and Instagram, they are typically focused on hate speech and other community-guidelines-violating content rather than misleading financial information. I would like to find out exactly how these auditing giants, in conjunction with the SEC, can team up with social media providers to create a safer space for investors to find useful information for their investment portfolios.

Methods

In order to find potential answers for my question, I would like to perform a detailed research project aimed at finding the most effective mode of eliminating information risk from social media. I will analyze research on trading psychology, current audit practices, and current social media content regulation practices. Utilizing this three-pronged research approach I will propose a few promising methods that could be plausibly implemented to minimize how often bad trades are performed off of faulty information from social media.

Expected Results

I believe that the best solution for minimizing social media related information risk will stem from one or multiple of the following approaches: censorship, punishment, corrective measures, or preventative measures. Censorship would add new criteria, related to bad financial information, to the community-regulating software that platforms like Twitter and Instagram use. Punishment would involve having the SEC establish punitive measures for those who circulate misleading financial information; however, this approach would rely on the ability of auditors or community regulators to spot faulty information warranting punishment. Corrective measures would look something like an official audit page on each platform that responds to misleading information in circulation by releasing warnings against following said information or by releasing correct information related to the involved stocks and companies. Preventative measures would require that all investors complete an information risk crash course before beginning to invest on any platform so they are more aware of the dangers of relying too heavily on social media for investing advice. Each option has varying degrees of audit-involvedness;

however, I hope at the minimum that audit could help do what it always does in establishing credibility and context for the material being circulated through social media and used by investors to determine their trades.

The findings of my research, in the form of an implementable strategy, will be published in an academic paper. I hope from there to be able to conduct a series of experiments testing the validity of my proposed strategy and the plausibility of its widespread use.

Conclusion

Investing is a great hobby or career pathway and has helped many people achieve financial freedom. The democratization of investing in recent years has made it available to more people than ever before; however, there need to be more precautions in place to help novice investors enter the treacherous waters of the stock market. Trades simply cannot be performed based on information gleaned from social media, which is the developing trend. I believe the solution to this problem lies in audit and in implementing a strategy specifically aimed at decreasing information risk stemming from social media. Audit is a practice built around protecting investors. In order to evolve and continue achieving this goal it has to be able to address the new source of information risk in our modernized world: social media.

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Budget

The two necessities for my project will be (1) my time & (2) access to various sources for my research. Since LMU already provides for (2) with its extensive access network to academic journals, trade journals, books, dissertations, and other scholarly and popular resources, the main consideration for budgeting is my time. I believe that research will take about 60 hours, which is roughly the amount of time I would allocate to a 2 unit course over the span of a semester. I believe this is a reasonable estimate as the Honors Senior Thesis course is allocated 4 units and involves research, experimentation, and exhibiting results. Seeing as I will only be doing the research portion in this segment of my project I believe an estimate of half the course work required for the Honors Senior Thesis is reasonable.

While the various academic resources I will utilize do entail costs, they are already sunk for the university who will pay for access to these resources whether I conduct my research or not. For that reason I believe it is appropriate to only consider the differential cost of my research to the university which will be in the form of hourly wages. At a pay rate of $15.00 an hour, which is minimum in LA county, for 60 hours, the total estimated cost of my project is $900.

Budget	Cost	Amount	Sub-Total	Total
Hourly Rate	$15.00/hr	60 hrs	$900	$900