

The Stock Market Game™



Week In Review

September 19, 2008

Important trading note: Today the SEC suspended short selling in 799 financial stocks, however, short selling these stocks is still possible in SMG if your SMG region allows short selling. A list of the banned stocks is available at: <http://www.cnbc.com/id/26787630> The ban is temporary and will end on October 2, 2008, and now to the *Week in Review*.

Suffice it to say there was a lot of news this week, but one of the bigger stories was about short selling and government regulation (or lack thereof), and we'll try to explain everything the best we can by starting with an analogy.

If you know the police officer that parks his car at the stop sign near your home is asleep from 9:30 am to 4:00 pm everyday, you might be tempted to run the stop sign. Or, you may realize that sooner or later, because everyone can run the stop sign without penalty, there's going to be a crash – a bad one – so you avoid the intersection altogether. And when the crash finally happens and people are killed and injured, you may form a neighborhood coalition of citizens to keep it from happening again.

Well, the crash finally happened this week and the Washington cops were stirred from their *laissez faire* slumbers and vowed to enforce the law. The outrage of the neighborhood coalition that included many on Wall Street, the public and Congress jolted the SEC into action to put the brakes on illegal short selling. Thus the stock crashes that toppled Lehman Brothers, forced Merrill Lynch to sell and were threatening to bring down Morgan Stanley and Goldman Sachs – suddenly stopped. On Thursday the cop was visibly awake and the market rallied as the bears scrambled to cover their short sales. This is probably not a panacea – there probably isn't one, but it could slow things down enough to stave off systemic failure. So you and your students may be asking, what the heck is short selling anyway? And more importantly, what's illegal short selling? Both are complicated, but important to understand if you want to know what happened this week.

Simply put, short selling is making a bet that a stock's price will fall. The practice is inherently risky, but can be very profitable if you're right about a stock's price going down. How it works is that you borrow a certain number of shares of stock from your broker – let's say 100 shares of a stock that's trading at \$10. Once you borrow the stock, you sell it. So now you have \$1000 of cash in your account and the buyer has the shares you borrowed from your broker. You are obligated to return the *shares* of stock to your broker in the future, not the \$1000 you received from selling the shares. So, if you sold the stock today for ten dollars and two weeks later the stock price drops to \$5, you can buy back the 100 shares in the stock market for \$500. You then return the 100 borrowed *shares* to your broker and keep a profit of \$500. Remember, you sold at \$10 and bought at \$5. It's buy low, sell high in reverse –sell high, buy low. However, if the stock goes up, you'll eventually be forced to buy it back for more than you sold it. That's the risky part.

Illegal short selling takes place at an institutional trading level. With illegal short selling, also known as naked short selling, the institution does not have and/or does not borrow the stock it is short selling. Essentially, a trader at an institution (brokerage, hedge fund, pension) has promised the buyer of the stock they are short selling (remember the first thing you do when you short sell is to sell) that they will borrow the stock and deliver it to the buyer within a reasonable period of time. Making the promise allows a trader to sell the stock before delivering the shares

to the buyer. In an illegal short sale, you sell the stock on your promise and never deliver the stock to the buyer. So you're selling something you don't have, which is illegal, no matter what you're selling. I can't sell you a car and never deliver it, especially if I never owned it in the first place. It's a fundamental foundation of capitalism.

If a trader is doing this intentionally (i.e., the trader knows the firm does not have the stock), the trader is not taking any risk and can manipulate the market by making large short sale trades on imaginary shares of a targeted stock in an attempt to drive the price down precipitously. If many people are doing this at once, you will see a targeted stock drop like a rock as we saw with Bear Sterns, Lehman Brothers, Merrill Lynch, and AIG. On Thursday, the SEC increased the penalties against this practice to include federal fraud charges. The SEC also vowed to investigate all "failure to deliver" notices. If your financial institution gets a failure to deliver notice, it means it never delivered the stock it promised to give to a buyer, as outlined above. There could be an "honest mistake" reason for not delivering the stock, or it may be criminal. But if no one ever asks you about it (like, say, the SEC), it starts to resemble the stop sign with the sleepy cop, and as we know, that doesn't end well.

Also announced this week, there will be an investigation by New York State Attorney General Andrew Cuomo to see if there were false rumors being spread about the troubled investment banks. Spreading false rumors is also illegal. Additionally, the Feds announced they will create a special government entity to buy the distressed sub-prime mortgage debt that started this crisis more than a year ago. The Dow closed up today 378 points.

Here in the financial district we hope this is the beginning of the end to this endless cycle of crises and not the end of the beginning, but whatever the future brings there are lessons to be learned. The turmoil in the stock market we have seen this week presents an outstanding teachable moment to speak with your students about risk. The core lesson, "What is Risk?" is available in the SMG's [Teacher Support Center](#). Also, there is a non-core lesson called "One Strategy for a Bear Market?" which explains short selling and is also available in the [Teacher Support Center](#).

Have a great weekend.

Regards,

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