

## Original Paper

# GME's Short Squeez and Market Regulation

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### **Abstract**

*GME Century Forbidding War is an event in which American retail investors force to force hedge funds. Based on the analysis of GME Century Forbidding War, this case analyzes the market supervision issues reflected behind this century war, and then explores the roles that enterprises, governments and individuals should play in the current financial market, thus further improving the financial market. Finally, it summarizes the inspiration of GME century's forced air war.*

### **Keywords**

*short squeez, market regulation*

## **1. Research Background**

The importance of a healthy and stable capital market as an important support for the real economy and a key driver of structural reforms on the supply side is self-evident. A significant indicator of the maturity of financial markets is their increasingly significant institutional trend. This trend gives full play to the professional advantages of institutional investors, including their profound professional knowledge, huge capital scale, rich information resources and rational investment strategies, which together form the cornerstone of the stable development of the capital market. It is worth noting that the institutionalization process is not intended to marginalize or exclude individual investors, but aims to build a more professional and rational investment environment, which will facilitate investors seeking higher-level investment services. In this process, protecting the interests of investors has become an indispensable responsibility and mission of various institutions, aiming at minimizing the potential risks and unnecessary losses of investors. Taking the game station (GME) event in the global capital market as a mirror, the case profoundly reveals the new form of interaction between retail investors and institutions, and the possible extreme impact of market sentiment fluctuations on asset prices. For the China stock market, the GME event is not only an opportunity for external observation, but also a valuable resource for reflection and introspection.

GME century forced air war is also called GameStop (GME.US) game station air-raid event. In early

January 2021, the stock price of GameStop, an American video game retailer, experienced an unprecedented air-raided storm. The incident mainly originated from the collective action of the R/Wall Street Bets sub-section on Reddit social platform and many online trading communities, who launched a collective buying wave of GameStop shares by using trading platforms such as Robinhood, which eventually led to some hedge funds suffering significant losses. Game station was founded in 1996, is a game retailer, specializing in the purchase of second-hand video games, five sets sold for only \$10. However, with the rise of the Internet, more and more people began to buy games from the Internet, and its retail model has always been considered outdated. In recent years, the stock price has been at a low level, dropping from \$28 in 2016 to \$3 in 2019, and becoming the most short-selling stock in 2020. Under the background of China's increasingly institutional financial market, focusing on the core demand of capital market stability, and deeply analyzing the behavior patterns and conflicts between individual investors and institutional investors in the game station event, it has far-reaching implications for the steady development of China's stock market. The incident not only reveals the significant differences between the two in investment strategies, information acquisition and market influence, but also highlights how the potential conflicts between the two affect and affect the overall stability of the market.

## 2. Sorting out GME Events

### 2.1 What Is Short Selling?

Short isStock futuresA common way of operating in the market, as opposed to doing more, in which the operator expects the stock to be traded.forward marketThere will be a downward trend, they will sell their chips at the market price, or borrow the corresponding underlying assets to sell them for cash, etcfuturesBuy after falling to earn an intermediate price difference.

The short selling mechanism plays an indispensable positive role in the market to a certain extent. First of all, the shorting report can attract the attention of the banking industry and enable them to deeply analyze the potential risk areas such as the operation status and capital chain status of the enterprise through detailed audit and investigation, which is crucial to the effective management of loan risk. In addition, the short selling mechanism provides investors with another means to express their expectations of the stock price, enriching the diversity of investment strategies and allowing market participants to flexibly choose the operation direction based on their own judgment. Further, the short selling mechanism helps to increase the liquidity of the market, as it encourages more diversified trading behavior and facilitates the full exchange of information and the effective discovery of prices. At the same time, shorting, as a natural check and balance to unilateral trading, helps to correct the over-optimism and unreasonable high valuation in the market, and urges the stock price to return to its intrinsic value. In such a market, the bubble has been effectively squeezed after being fully questioned and challenged by the short force, and the stock price is more often supported by the fundamentals of the enterprise, thus significantly reducing the risk of drastic fluctuations in the market and even stock

market crash.

Malicious shorting refers to the fact that some shorting agencies make a hasty negative judgment on the target company in the absence of conclusive evidence, which in turn leads to an irrational drop in the company's share price. Even if the target listed company itself operates steadily and does not show any problems, such malicious acts are still enough to stir up waves of market public opinion and produce a series of negative effects. It not only misled the public, but also triggered the "herd mentality" of small and medium-sized investors, i.e. herding effect, which exacerbated the drastic fluctuations in the company's share price. This phenomenon has not only failed to effectively play the positive role of the short selling mechanism in exposing financial fraud, but has instead become a negative factor that disturbs market order and undermines market fairness.

In view of this, in the process of promoting the further development and improvement of the short selling mechanism, China must simultaneously construct a comprehensive and effective prevention and control system, aiming at reducing or even eliminating the occurrence of malicious short selling events. This requires us to comprehensively implement policies from the perspectives of system construction, strengthening of supervision, improvement of transparency of information disclosure and investor education to ensure the healthy and stable capital market, safeguard the legitimate rights and interests of investors, and promote the rational allocation of market resources and sustainable economic development.

## *2.2 The Process and Analysis of the War*

### *2.2.1 The process of the War*

On January 19, 2021, Citron Research, a well-known short seller, released a detailed short-selling research report on GameStop, claiming that there was a serious bubble in the company's stock price and that its reasonable valuation should be limited to the \$20 range (GameStop closed at \$39.36 that day, well above this estimate). Subsequently, the report triggered a chain reaction in the market. Many hedge funds joined in short selling one after another, betting on the continued decline of GameStop's share price, and even led to the short selling positions circulating in the market far exceeding the actual total equity of GameStop, reaching an alarming 140%. However, the stock price of GameStop rose against the trend and the shareholders showed strong sentiment of holding back the sale, which made it difficult for the short sellers to find enough chips in the market to cover their options contracts, and thus suffered a huge loss of nearly \$1.6 billion in just one day. And the situation reached a more significant turning point on January 26, when GameStop's share price soared 92.7%. Subsequently, Tesla's chief executive officer released a message supporting GameStop through social media, which was like a shot in the arm and greatly stimulated the enthusiasm and confidence of retail investors. Driven by the positive news, GameStop's share price surged another 42% in after-hours trading, further exacerbating market volatility and concerns. On January 27, 2021, there was still no sign of a slowdown in the growth of the game station. It rose by 140% once after the opening, triggering a suspension of trading at least twice. In the Japanese trading market, long forces continue to dominate,

while short forces are gradually showing signs of retreat. On the 29th, Citron Research, which had previously published a short report on Game Posthouse, announced a major strategic adjustment on the social media platform: "After more than 20 years of short research practice, Citron decided to stop publishing a short report and instead focus on identifying and recommending long trading opportunities for individual investors. This transformation marks an important transformation in Citron's future business direction. "

#### 2.2.2 Reasons for the Increase in Share Price

In this forcing process, there are three main forces pushing up the stock price. First, retail speculators. The motivation of this kind of people is actually very obvious. Large hedge funds are all shorting. If retail investors want to guarantee their own interests, they must hedge short positions. Naturally, they change from a zero position to a long position. Second, in the spot trading market, there are many short positions in the hedge fund group, which are short selling operations through the short selling mechanism, and most of them have margin requirements. In order to solve the problem that spot short sellers are exposed to the risk of short positions when the market is experiencing a boom, they have to take a position-closing measure, i.e. buy back the corresponding securities in the secondary market to cover their short positions, which equates to short sellers having to buy back shares from the market to fill their previous short-selling gap. In addition, the dynamics of the options market also have an indirect and significant impact on the spot market. Specifically, retail investors actively purchase call options, and as important participants in the options market, institutions and market makers are often the sellers of call options. When these market makers experience large floating losses in the options market, they increase their holdings in the secondary market to hedge their exposure. This process, the so-called Delta hedging strategy, although originally intended for risk management, inadvertently brings together a new multi-player force in the spot market and becomes the third important multi-player force besides retail investors and original bulls.

#### 3. The reason for 3.GME's high short selling multiple

The multiple of shorting has reached 140% over the course of the event, which means that all equity is not sufficient to cover the number of short sellers. The reason for GME's 140% short position is that the same stock has been sold short many times. Because the short position is the number of shares sold short divided by the number of shares in circulation, in most cases this number is less than 100%, and now the additional 40% is because the shares have been sold short many times.

### 3. Follow-up to the GME Event

Since the outbreak of the GME incident, many similar stocks have shown a joint trend with no signs of slowing down, indicating that a similar "doomsday round" phenomenon may be formed. The "doomsday round" refers to a situation in which an option changes from virtual to real as it nears maturity. Once this phenomenon occurs, it is often beneficial to retail investors and unfavorable to institutions. For a market maker or an investor who sells a subscription, it would be extremely

disadvantageous for him to turn the option from a sham to a real one. Therefore, if the GME stock continues to boom at the maturity date, it will cause a large number of virtual options to be converted into real options, which will be disastrous for the option sellers. In fact, this catastrophic risk is on the horizon. On January 22, 2021, GME shares rose by 94% before opening, and once rose by nearly 110% after opening. The day's high hit US\$ 414 and triggered the fuse mechanism. The final closing price rose by nearly 68%. The cumulative increase in one week was as high as 400%. The closing price reached US\$ 325, a 16-fold increase over the closing price of US\$ 19.95 on January 12. Against this background, the virtual call option quickly disappears. In the face of this situation, the shorting agency can only reduce this risk through the covering operation, i.e. the urgent purchase of shares in the secondary market to close the short position, otherwise it will be helpless. For retail investors, not everyone will suffer losses. In fact, a significant portion of retail investors will make a profit, because many retail investors bought shares when they were only in their thirties, and now their shares have soared to \$400, making a profit with only a slight unwinding. Only the last batch of retail investors who take orders at high positions can truly become losers.

### **3. Market Supervision in the GME Event and Its Implications**

#### *3.1 Systematic Risks Caused by Imperfect Market Mechanism*

This GME forcing event can be seen that there are design flaws in the mechanism of the U.S. capital market. The systematic and regulatory loopholes have led to the disorder in the market transactions, and ultimately the stock price fluctuates greatly. In this incident, due to the joint participation of the short-selling institutions and the retail investors, the stock price has been rising. However, in practice, the small and medium-sized investors are undoubtedly the ones most affected by the changes in share prices. Due to the lack of funds and information, if there is no short-selling institutions, they will inevitably bring irreparable losses to the small and medium-sized investors. This also reflects the lack of a fair trading environment in the US capital market, coupled with the lack of relevant regulatory mechanisms by the government, leading to the emergence of speculative trading and short-term behavior, which reduces the efficiency of the capital market. In view of this, in the Internet era, while implementing the short selling mechanism, attention should be paid to the prevention of the relevant regulatory system and systematic risks of short selling, and promote the combination of the short selling mechanism and government actions, so as to ensure the market efficiency while improving the efficiency.

#### *3.2 The Confusion of the Market Pricing Mechanism*

The stock price in the effective capital market is mainly determined by the demand of investors. Among them, the improvement of information disclosure mechanism helps to ease the problem of information asymmetry of investors, so that they can more accurately grasp the financial status and operation of the company, and make relatively rational investment choices, thus enhancing the effectiveness of share prices and promoting the sound development of capital markets. However, it is worth noting that

investors, especially retail investors, are mostly speculators. The main purpose of their investment in the capital market is to obtain profits and earn price differences. In addition, due to the limited professional level, their investment choices may contain irrational factors, which may cause excessive fluctuations in the stock price. In addition to the rapid development of the Internet and the rapid spread of information on social media, these may aggravate investors' confusion. Among them, the echo chamber effect may distort investors' cognition and lead them to make wrong investment decisions, thus weakening market efficiency and causing negative economic impact. Take the game station stock price fluctuation event as an example, retail investors in social media are trying to change the trading rules so as to disconnect the stock trading logic from corporate fundamentals and turn it into a zero-sum game for short sellers. This effect not only had a significant impact on the game station, but also spread to other companies, such as AMC Cinema Company in the United States and Blackberry Company in Canada, which were also shorted by hedge funds. Their share prices also experienced similar abnormal fluctuations. Among them, the speculative trend has spread to the whole market to some extent, resulting in a series of trading-type open-end index funds (ETF) related to retail stocks or small-cap stocks that have experienced significant fluctuations. Such abnormal fluctuations in share prices that deviate from corporate fundamentals will undoubtedly reduce the efficiency of resource allocation in capital markets and undermine their integrity and fairness. Therefore, improving the quality of information disclosure and strengthening the dissemination of formal information such as corporate earnings reports, operating announcements and regulatory enforcement are of great significance to help investors accurately understand the real operating conditions of the company.

### *3.3 The Stock Price Is Arbitrarily Manipulated*

With the rapid development of the Internet, there are many platforms for investors, especially retail investors, to access information and actively explore. Such as social media, news release platforms, investment research websites, rating service websites, message boards, chat rooms and various forums. However, these online platforms contain potential risks of market manipulation that deserve high attention. This is because fraudsters may use these platforms to spread false or misleading information in an attempt to manipulate the company's share price, thus seeking personal gain at the expense of other investors. Specifically, people who intend to disrupt the market order can create public opinions by publishing false or misleading information through various major media. There may be public opinions of a rush to buy shares, or they may fabricate negative rumors to induce shareholders to sell shares. In short, they will gain benefits through the price difference of shares. If investors do not have sufficient expertise and sensitivity, they may be cheated and suffer losses. In the game station stock price fluctuation event, the influence of gossip even surpasses the influence of the company's formal information, which is extremely dangerous. The popularity of the Internet makes communication more convenient, and a large number of retail investors can realize real-time information exchange. The portfolio shared by social media users in the forum makes the investment behavior between institutional investors and retail investors more transparent. The convenience of information

transmission and the transparency of the investment portfolio have further promoted the coordination among retail investors. Therefore, it is necessary to accurately identify and define the stock price manipulation factors in the Internet platform, not only to ensure the reasonable discussion and exchange of public information of the company, but also to effectively prevent the dissemination of misleading content that deviates from the true information of the company.

#### 4. Enlightenment

The GME war seems to be a victory for retail investors, but in essence it is a game between short-selling institutions. With the participation of short-selling institutions, small and medium-sized investors have avoided the impact of stock price fluctuations. Besides declaring the victory of retail investors on face, it also exposes some problems in the supervision of the US securities market, such as the nonstandard pricing strategy, the lack of a fair trading environment, the existence of systematic risks and the random manipulation of stock prices. This also provides some experience for the operation of China's capital market. The operation of the capital market should be in a safe and stable environment, and the random fluctuation of stock prices will inevitably bring investors.

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