TRADING

Predatory Trading

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Large traders fear a forced liquidation, especially if their need to liquidate is known by other traders. For example, hedge funds with (nearing) margin calls may need to liquidate, and this could be known to certain counterparties such as the bank financing the trade.

Similarly, traders who use portfolio insurance, stop-loss orders, or other risk management strategies can be known to liquidate in response to price drops; a short-seller may need to cover his position if the price increases significantly; certain institutions have an incentive to liquidate bonds that are downgraded or in default; and, intermediaries who take on large derivative positions must hedge them by trading the underlying security. A forced liquidation is often very costly since it is associated with large price impact and low liquidity.

This paper provides a new framework for studying the phenomenon of predatory trading. Predatory trading is important in connection with large security trades in illiquid markets. We show that predatory trading leads to price overshooting and amplifies a large trader's liquidation cost and default risk. Hence, the risk management strategy of large traders should account for "predation risk."

Predatory trading enhances systemic risk, since a financial shock to one trader may spill over and trigger a crisis for the whole financial sector. Consequently, our analysis provides an argument in favor of coordinated actions by regulators or bailouts. Our analysis has further implications for the regulation of securities trading and disclosure rules of large traders, and it explains certain advantages of trading halts, batch auctions and of the up-tick rule.

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