



Strategic trading behavior and price distortion in a manipulated market: anatomy of a squeeze[☆]

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Available online 23 February 2005

Abstract

This paper investigates an attempted delivery squeeze in a bond futures contract traded in London. Using cash and futures trades of dealers and customers, we analyze their strategic trading behavior, price distortion, and learning in a market manipulation setting. We argue that marked differences in settlement failure penalties in the cash and futures markets create conditions that favor squeezes. We recommend that regulators require special flagging of forward term repurchase agreements on the key deliverables that span futures contract maturity dates, and that exchanges mark-to-market

[☆]We are very grateful to the Financial Services Authority (FSA) for providing us data on government bond dealers' positions and trades. We thank the Bank of England and Alfredo Bequillard of Lehman Brothers for providing Gilt price data. We are grateful to Centre for Hedge Fund Research and Education at the London Business School for financial support. We thank Sharon Dittrich and Munir Dauhajre of Merrill Lynch and Daniel Grumbacher of the CBOT for helpful discussions, and George Oldfield, William Silber, and Wanda Wallace for useful comments. We are grateful to Steve Figlewski, Francis Longstaff, Pete Kyle, Kjell Nyborg, Stephen Craig Pirrong, Ilya Strebulaev, Avaniidhar Subrahmanyam, S. Viswanathan, John Whitmore, participants at the EFA 2002 meetings in Berlin, and WFA 2003 meetings in Los Cabos for many useful comments. We are thankful to Purnendu Nath and Rajesh Sivaraman for excellent research assistance. This research was undertaken while Pradeep Yadav was visiting the Stern School of Business at New York University 2001 to 2002 and the Anderson School of Business at UCLA 2002 to 2003.

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their contract specifications more frequently, or consider a cash-settled contract on a basket of bonds.

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JEL classification: G10; G20; G24

Keywords: Price manipulation; Futures markets; Squeeze

1. Introduction

History is filled with instances of individuals and corporations manipulating securities markets and attempting to generate high private returns from acquiring and exercising market power in securities trading. Well-publicized major manipulation episodes have occurred in bond markets,¹ in commodity markets and their futures contracts,² and also in equity markets.³ Manipulative grabs for pricing power are neither uncommon, nor even have the appearance of impropriety, in self-regulated over-the-counter markets such as the government bond markets of the United Kingdom and the United States. For example, a U.K. or U.S. bond dealing firm might acquire a large position in a particular issue and then partially restrict its availability in the market. Such an action could turn the issue “special” so that the firm could generate trading profits on its bond inventory and/or obtain disproportionately good financing rates using the bond as collateral.⁴

Even though there have been innumerable cases of often serious market manipulations reported in securities markets worldwide, surprisingly little is documented about the trading behavior of major players in manipulated markets. Early empirical research on market manipulation is largely confined to the study of

¹Examples include the Eurex BOBL squeeze in March 2001, the London International Financial Futures and Options Exchange’s (LIFFE’s) Italian Government Bond futures contract squeeze in September 1997, the Tokyo Stock Exchange September 1996 Japanese Government Bond futures squeeze, the squeeze pressures in the Chicago Board of Trade’s Treasury bond futures contract through 1993 and 1994, the Salomon Brothers U.S. Treasury note squeeze in May 1991, and the alleged cornering of the 2016 U.S. Treasury bond issue by Japanese investors in the February 1986 auction.

²There have been innumerable alleged attempts to corner commodities markets, for example, episodes in the oil (Exxon, 1996), tin (1980 to 1981 and 1984 to 1985), silver (the Hunt family, 1979 to 1980), and soybean (the Hunts again, 1977) markets, to name a few. See Pirrong (1995) for numerous episodes of market manipulation at the Chicago Board of Trade and other U.S. and international exchanges, and the shortcomings of self-regulation by the exchanges.

³Jarrow (1992) relates a collection of early references on attempted corners in individual common stocks. Lefebvre’s (1994) lively *Reminiscences of a Stock Operator* contains several discussions of manipulations. A casual web search also yields a large number of press reports of market manipulation in equity markets. In particular, in the U.S. in battles involving corporate insiders, it is not uncommon for these insiders to collude with shareholders to engineer short squeezes, i.e., situations in which short-sellers are forced to cover their short position due to their not being able to borrow shares because these shares have been withdrawn from the share lending market.

⁴Duffie (1996) and Chatterjee and Jarrow (1998) discuss causes of repo specialness. See Jordan and Jordan (1998) for an empirical analysis of bond pricing effects of repo specialness.

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