Multimarket Informed Trading

Felix Fattinger*

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Abstract

The question which mechanisms how strongly affect informed traders' choice of their preferred trading venue(s) is still unresolved. This paper expands the existing literature by proposing a more realistic model of multimarket informed trading in which heterogeneous and risk-averse informed agents make their trading decision based on an imperfect price signal. We investigate the driving forces behind informed trading involving both a stock and its corresponding options when the private signal exhibits a potentially significant price impact (jump). Assuming rational expectations, we derive a pooling equilibrium in which informed agents simultaneously trade in both the stock and the options market. We then numerically show that, in equilibrium, conditional informed stock trading is an increasing and concave function in the overall probability of informed trading. An empirical analysis of trading data prior to US M&A announcements provides evidence for this structural relationship postulated by our model.

Keywords: Informed trading, asymmetric information, options, jumps, risk aversion, mergers and acquisitions

*Department of Banking and Finance, University of Zurich, Plattenstrasse 32, CH-8032 Zurich, Switzerland. E-mail: felix.fattinger@bf.uzh.ch