 Liability Trading 1

The trader on the equities desk at your firm who is assigned to do market-making has called in sick and you've been given a chance to fill in the role. Being your first opportunity to trade, you're extremely excited at the opportunity.

The stock that you have been assigned to trade is Harbringer Co, (Ticker: HAR). The stock generally exhibits very little intra-day volatility and the managing director is quite comfortable with you taking over the reins.

Due to the capital adequacy rules at the bank, you have a trading limit of 10,000 shares net (that is long or short). In addition, several orders to buy and sell shares sourced from your bank's brokers will directly trade with your inventory, and you will be notified whenever shares are deposited or taken out of your inventory. These orders will be for 5000 shares at a time.

In the morning briefing, your Managing Director has provided you with the following advice:

“It’s the summer and nothing’s really going on. We expect that the market will be flat for most of the day, so we really don’t see much action coming into this stock. Just submit bids and offers into the order book and wait for them to get filled. If you ever find yourself getting too long, lower your offer prices and cancel some bids, vice versa if you’re getting too short. If the spread between your bids and asks (offers) are too narrow, you’ll get run over. Likewise if they’re too wide, you won’t get fills. You probably want to quote a bid-ask spread of around 10 cents. Risk management is key; don’t let the market move too far against in you any direction. If that happens, just close out your position and start over. Robbie has some retail client orders that will get filled directly out of your inventory. We’ll fill them with a premium/discount of 5 cents, so you shouldn’t lose money on those trades if you unwind them quickly enough. Breaking your trading limits a few times because of Robbie’s orders\(^1\) is fine, but don’t let it become commonplace. Good luck.”

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\(^1\) If you are long 10,000 shares, and then you receive a client fill (called an endowment in the software) for 5000 shares, you will be long 15,000 shares- (that means you are over your trading limit). The software will restrict you from buying more shares, and you should try to sell shares to get back below your limit. Since you are not given notice as to the timing (or the direction) of client orders, you will not be fined in this case for breaching your limits.

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Liability Trading Simulation #1 – LT1

During the LT1 simulation, you are responsible for submitting market and limit orders so that you are an active participant in the market for HAR shares. Your goal is to generate trading profits through the bid-ask spread; that is by purchasing shares at the bid price and selling shares at the ask price.

Your trading limit is 10,000 shares, meaning that you cannot submit trades that will cause you to be long or short more than 10,000 shares. However, retail trades that are sourced from brokers may be placed into your account causing you to exceed your trading limit. If this occurs, you should submit trades to get under your trade limit as soon as possible.

Discussion Questions and Follow Up:

(1) What is the bid-ask spread and how does it affect market orders versus limit orders?

(2) Explain the difference between the market's bid-ask spread and the bid-ask spread that you are currently quoting into the market.

(3) Elaborate on what your MD was saying about “getting run over” if your bid/ask spread is too narrow, and “not getting fills” if your bid/ask spread is too wide.

(4) Some traders say that you should "never cross the bid-ask spread". What does that advice mean, and what are the implications of that?