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Title: Rogue Traders

Abstract:

Investing on behalf of a firm, a trader can feign personal skill by committing fraud that with high probability remains undetected and generates small gains, but that with low probability bankrupts the firm, offsetting ostensible gains. Honesty requires enough skin in the game: if two traders with isoelastic preferences operate in continuous-time and one of them is honest, the other is honest as long as the respective fraction of capital is above an endogenous fraud threshold that depends on the trader's preferences and skill. If both traders can cheat, they reach a Nash equilibrium in which the fraud threshold of each of them is lower than if the other one were honest. More skill, higher risk aversion, longer horizons, and greater volatility all lead to honesty on a wider range of capital allocations between the traders.

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3870658