

CONTENTS

Preface xii

Introduction 1

- 0.1 What is This Book About? 1
- 0.2 Why Should We Care? 4
- 0.3 Some Puzzles 5
- 0.4 The Three Dimensions of Liquidity 8
 - 0.4.1 Market Liquidity 8
 - 0.4.2 Funding Liquidity 9
 - 0.4.3 Monetary Liquidity 10

PART ONE Institutions

- 1 Trading Mechanics and Market Structure 15
 - 1.1 Introduction 15
 - 1.2 Limit Order Markets and Dealer Markets 17
 - 1.2.1 Limit Order Markets 17
 - 1.2.2 Dealer Markets 23
 - 1.2.3 Hybrid Markets 27
 - 1.2.4 Market Transparency 28
 - 1.3 Does Market Structure Matter? 31
 - 1.4 Evolution of Market Structure 32
 - 1.4.1 Who Makes the Rules? 32
 - 1.4.2 Competition between Exchanges 34
 - 1.4.3 Automation 37
 - 1.5 Further Reading 44
 - 1.6 Exercises 44
- 2 Measuring Liquidity 46
 - 2.1 Introduction 46
 - 2.2 Measures of the Spread 49
 - 2.2.1 The Quoted Spread 49
 - 2.2.2 The Effective Spread 50

- 2.2.3 The Realized Spread 53
- 2.3 Other Measures of Implicit Trading Costs 55
 - 2.3.1 Volume-weighted Average Price 55
 - 2.3.2 Measures Based on Price Impact 56
 - 2.3.3 Non-trading Measures 58
 - 2.3.4 Measures Based on Return Covariance 59
- 2.4 Implementation Shortfall 65
- 2.5 Hands-on Estimation of Transaction Costs 68
- 2.6 Further Reading 68
- 2.7 Appendix 69
- 2.8 Exercises 72
- 3 Order Flow, Liquidity, and Securities Price Dynamics 77
 - 3.1 Introduction 77
 - 3.2 Price Dynamics and the Efficient Market Hypothesis 81
 - 3.3 Price Dynamics with Informative Order Flow 84
 - 3.3.1 The Glosten-Milgrom Model 85
 - 3.3.2 The Determinants of the Bid-Ask Spread 87
 - 3.3.3 How Do Dealers Revise their Quotes? 92
 - 3.3.4 Price Discovery 94
 - 3.3.5 The Implications for Price Movements and Volatility 98
 - 3.4 Price Dynamics with Order-Processing Costs 101
 - 3.4.1 Bid-Ask Spread with Order-Processing Costs 101
 - 3.4.2 Price Dynamics with Order-Processing and Adverse-Selection Costs 102
 - 3.5 Price Dynamics with Inventory Risk 106
 - 3.5.1 A Two-Period Model 108
 - 3.5.2 A Multi-Period Model 112
 - 3.5.3 The dynamics of prices and inventories 115
 - 3.6 The Full Picture 120
 - 3.7 Further Reading 122
 - 3.8 Exercises 123
- 4 Trade Size and Market Depth 132
 - 4.1 Introduction 132
 - 4.2 Market Depth under Asymmetric Information 134
 - 4.2.1 Learning from Order Size 135
 - 4.2.2 Perfectly Competitive Dealers 137
 - 4.2.3 The Informed Trader's Order Placement Strategy 140
 - 4.2.4 Imperfectly Competitive Dealers 144
 - 4.3 Market Depth with Inventory Risk 148

- 4.3.1 Perfectly Competitive Dealers 148
- 4.3.2 Imperfectly Competitive Dealers 151
- 4.4 Further Reading 153
- 4.5 Appendix A 154
- 4.6 Appendix B 156
- 4.7 Exercises 157

- 5 Estimating the Determinants of Market Illiquidity 163
 - 5.1 Introduction 163
 - 5.2 Price Impact Regressions 165
 - 5.2.1 Without Inventory Costs 166
 - 5.2.2 With Inventory Costs 170
 - 5.3 Measuring the Permanent Impact of Trades 176
 - 5.4 Probability of Informed Trading (PIN) 179
 - 5.5 Further Reading 184
 - 5.6 Exercises 184

PART TWO Market Design and Regulation

- 6 Limit Order Book Markets 191
 - 6.1 Introduction 191
 - 6.2 A Model of the Limit Order Book (LOB) 193
 - 6.2.1 The Market Environment 193
 - 6.2.2 Execution Probability and Order Submission Cost 196
 - 6.2.3 Limit Order Trading with Informed Investors 198
 - 6.3 The Design of Limit Order Book Markets 204
 - 6.3.1 Tick Size 204
 - 6.3.2 Priority Rules 207
 - 6.3.3 Hybrid LOB Markets 209
 - 6.4 The Make or Take Decision in LOB Markets 213
 - 6.4.1 Risk of Being Picked Off and Risk of Non-Execution 214
 - 6.4.2 Bid-Ask Spreads and Execution Risk 217
 - 6.4.3 Bid-Ask Spreads and Volatility 220
 - 6.4.4 Indexed Limit Orders, Monitoring, and Algorithmic Trading 223
 - 6.4.5 Order Flow and the State of the LOB 225
 - 6.5 Further Reading 230
 - 6.6 Appendix 232
 - 6.7 Exercises 232

- 7 Market Fragmentation 236
 - 7.1 Introduction 236
 - 7.2 The Costs of Fragmentation 241
 - 7.2.1 Information Effects 242
 - 7.2.2 Risk-sharing Effects 246
 - 7.2.3 Competition among Liquidity Suppliers 248
 - 7.2.4 Fragmentation and the Broker-Client Relationship 251
 - 7.3 Liquidity Externalities 253
 - 7.3.1 Liquidity Begets Liquidity 254
 - 7.3.2 Low-liquidity Traps 256
 - 7.4 The Benefits of Fragmentation 256
 - 7.4.1 Curbing the Pricing Power of Exchanges 256
 - 7.4.2 Sharper Competition among Liquidity Providers 259
 - 7.4.3 Trade-throughs 265
 - 7.5 Regulation 268
 - 7.5.1 Regulation NMS 268
 - 7.5.2 MiFID 271
 - 7.6 Further Reading 275
 - 7.7 Exercises 275
- 8 Market Transparency 278
 - 8.1 Pre-trade Transparency 279
 - 8.1.1 Quote Transparency and Competition between Dealers 280
 - 8.1.2 Quote Transparency and Execution Risk 282
 - 8.1.3 Order Flow Transparency 284
 - 8.2 Post-trade Transparency 287
 - 8.3 Revealing Trading Motives 292
 - 8.4 Why are Markets so Opaque? 296
 - 8.4.1 Rent Extraction and Lobbying 297
 - 8.4.2 Opacity can Withstand Competition 298
 - 8.4.3 The Bright Side of Opacity 299
 - 8.5 Further Reading 301
 - 8.6 Exercises 303

PART THREE Implications for Asset Prices, Financial Crises, and Corporate Policies

- 9 Liquidity and Asset Prices 307
 - 9.1 Introduction 307

9.2	Illiquidity and Asset Prices	308
9.2.1	The Illiquidity Premium	308
9.2.2	Clientele Effects	313
9.2.3	Evidence	314
9.2.4	Asymmetric Information, Illiquidity, and Asset Returns	318
9.2.5	Illiquidity Premia in OTC Markets	320
9.3	Liquidity Risk and Asset Prices	322
9.4	Liquidity and Limits to Arbitrage	325
9.4.1	Risk of Early Liquidation as a Limit to Arbitrage	328
9.4.2	Limited Speculative Capital as a Barrier to Arbitrage	331
9.4.3	Implications for Market Making and Liquidity Crises	336
9.5	Correlated Order Flow and Noise Trader Risk	339
9.6	Further Reading	341
9.7	Appendix. The Derivation of the Search Model	343
9.8	Exercises	347
10	Liquidity, Price Discovery, and Corporate Policies	350
10.1	Introduction	350
10.2	Market Liquidity and Corporate Investment	351
10.3	Market Liquidity and Corporate Governance	354
10.4	Price Discovery, Corporate Investment, and Executive Compensation	360
10.4.1	Stock Prices and Investment Allocation	361
10.4.2	Stock Prices and Executive Compensation	368
10.5	Corporate Policies and Market Liquidity	372
10.5.1	Listing and Cross-listing	373
10.5.2	Designated Market Makers	375
10.5.3	Disclosure Policy	376
10.5.4	Capital Structure	380
10.6	Further Reading	382
10.7	Exercises	386
	References	389
	Author Index	410
	Subject Index	416