Liquidity provision contracts and market quality: Evidence from the New York Stock Exchange

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Question: Do we still need designated market makers in today's equity markets?

Today's markets are limit order markets where liquidity arises endogenously.

Today's markets have allowed development of an unprecedented pool of potential liquidity providers (the HFTs).

Today's U.S. equity markets are fast, safe, and facilitate the operation of highly sophisticated order submission strategies

But market makers may still be relevant…

- We know that HFT traders stop offering liquidity in times of market stress.
- Liquidity supply is an opaque industry.
- Liquidity is usually hard to predict, giving rise to liquidity risk.
- Market maker contracts are customizable and MM may get paid by exchange, issuer, or other interested parties.
- Getting equity markets designed properly may have sizeable welfare consequences.

Econometric/interpretation issues

- Authors use RDD design, which is generally appropriate given the nature of DMM enhancements.
  - But what if other traders trade/respond along the same timeline as DMMs?
  - What if HFTs trade strategically around DMM contract enhancements?
  - Then we may not be able to differentiate HFTs and other traders from DMMs
  - Given the opacity of this industry, how can we get around this issue?

Main exchange and “other” markets

- In principle, all traders (including MM!) can access several markets contemporaneously. (and all can potentially use strategies around DMM contract enhancement).
- Is it possible to extract strategies that use multiple markets?
  - For example, DMM can “borrow” liquidity from one market and supply it to another. This will affect regression estimates but is probably socially useless.

Other issues

- Are we sure that all MMs are indeed identified as such? There might be incentives to conceal paid MM activity (or the timing of enhancements to their contracts).
- This paper looks only at effects of exchange-paid DMM contracts. Can you say anything about the change in effects when the DMM contracts are issuer-paid?

Conclusions

- Results partially expected.
- Empirical design appropriate.
- Most yield for improvements and interpretation:
  - Identify other traders' strategies and contrast them empirically.
  - See how this might affect conclusions.
- Big and timely question.