Market (Micro-)Structure for Asset Management

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Market Microstructure

—is the study of how transactions take place.
—is closely related to the concept of liquidity.
It has descriptive and prescriptive aspects.

In the news:

▷ *Flash Crash* of May 16, 2010
US Equity Markets, pre-1998:

- **NYSE :: Specialist Market**
  - Highly Centralized
  - Physical Place important

- **NASDAQ :: Dealer Market**
  - Most trades routed to a dealer
  - No physical place
Dealers and specialists could make large profits from the bid-ask spread.

- **Tick Size:** 1/8 (anachronism).
  - Interesting side note: Bernard Madoff invented purchasing order flow
- **NASDAQ Dealer Collusion** (Odd-eighth avoidance).
- Traders could place limit orders, but questions of exposure.
- (And things were much worse in US options markets).
The Great Trading Revolution

Regulation:
- Decimalization (!)
- (Forced) Display of Limit Orders.
- Multiple Listing of Options

Technology :: High Frequency Trading (Really: High Frequency Quoting – fishing.)
- Program Trading (now 15%).

Fragmentation:
- Dark Pools.
- Electronic Trading Networks

Competition amongst Exchanges: Maker-Taker: rebate to liquidity providers / charge access fee to liquidity takers.
The current landscape

Bid-ask spreads are much tighter.
Public quotes are much shallower.
Dealers no longer profit from the bid-ask spread. Emphasis is placed on the information in the order flow (*front running*).
Asset Managers

- Make trading costs *and execution* a point of distinction.
  - *Measure* both—and benchmark.
  - Don’t give away order flow information.
  - Possible value in relationships.
- Recognize the effects of the new environment:
  - Heightened volatility :: **Reconsider** Limit / Stop Orders.
  - Black Pools *seem* an ideal venue—but are they subject to manipulation?