

The impact of preferencing on execution quality[☆]

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Abstract

We examine the impact of preferencing on execution quality for NASDAQ and NYSE-listed stocks. Our theoretical model demonstrates that realized spreads are more reliable than effective spreads in the presence of preferencing, but even realized spreads are a poor measure of execution quality if the stocks being compared have different degrees of information asymmetry. We provide a new measure of the costs of preferencing that is independent of asymmetric information. Using data from the SEC 11Ac1-5 reports for marketable orders of up to 2000 shares, we find that both realized spreads and our preferencing measure are lower for NYSE-listed stocks.

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1. Introduction

Stocks in the U.S. trade not only on their primary exchange, but also in other markets. While alternative market centers can compete for order flow by posting aggressive quotes, they also obtain orders through preferencing agreements. Preferencing agreements between market centers and brokers who route customers' orders allow market centers to obtain order flow regardless of their quotes. Although these agreements are fairly widespread for both New York Stock Exchange (NYSE) listed and NASDAQ stocks, they are much more prevalent for NASDAQ stocks. Accordingly, to estimate the impact of preferencing on

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execution quality, we compare various measures of execution costs across these two markets.

Preferencing agreements can take various forms. In some cases, the preferencing broker agrees to send customer orders to the preferred market center, which in turn agrees to follow predetermined procedures for setting the execution price, such as agreeing to match the national best bid or offer. The preferred market center may also pay the preferencing broker for the routed orders. In another case, called *internalization*, the preferred market center and the broker are part of the same corporation. Both theory and anecdotal evidence suggest that market makers try to use preferencing to attract orders from investors whose trading decisions are not based on short-term price information.

Proponents of preferencing argue that as long as preferred orders are given reasonable prices, customers are not disadvantaged. In fact, the U.S. Securities and Exchange Commission's 1997 "Report on the Practice of Preferencing" finds effective spreads are no higher at preferred market centers, and thus concludes that preferencing does not diminish market quality. Battalio (1997), Hansch et al. (1999), and Peterson and Sirri (2003) have examined effective spreads and also find that preferencing has no clear negative impact on execution costs. Others assert that preferencing reduces dealers' incentives to offer competitive execution and limits the ability of orders to interact, both of which may harm investors. For example, Huang and Stoll (1996) and Chung et al. (2004), among others, document a positive relationship between preferencing and execution costs.

To guide our analysis, we extend the Kyle (1985) model to include preferencing of a portion of the uninformed order flow. Our model shows that preferred market makers profit at the expense of both uninformed and informed investors even though the preferred market maker matches the effective spreads given to non-preferred uninformed orders. As the fraction of order flow that is preferred increases, uninformed traders in both the primary and preferred markets pay wider spreads, and the informed trader scales back trading, thereby reducing profits. More than half of the preferred market maker's gain from preferencing comes at the expense of the uninformed traders.

Our model also shows that differences in effective spreads do not fully reflect the negative impact of preferencing on investors because they capture not merely dealers' profits, but also the profits of informed traders. Because the increase in dealer profits is partially offset by a decline in informed traders' profits, effective spreads underestimate the true costs of preferencing. Realized spreads, in contrast, reflect only dealer profits and thus capture the combined cost of preferencing borne by the uninformed and informed traders. This suggests that realized spreads are a better measure of market quality than effective spreads in the presence of different degrees of preferencing. Still, realized and effective spreads are equally sensitive in percentage terms to differences in information asymmetry when preferencing dealers match the effective spread paid by uninformed traders in the competitive portion of the market. This implies that *both* realized and effective spreads are poor measures of execution quality if the stocks that are compared have differences in asymmetric information.

Our model yields a new measure of preferencing that, unlike effective and realized spreads, completely controls for the level of information asymmetry. This makes our measure useful for comparisons across stocks and across exchanges. Because dealer profits increase with the degree of preferencing, this new measure provides an indication of the extent of the costs preferencing imposes on traders.

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