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Journal of Financial Economics 66 (2002) 139–167

JOURNAL OF Financial ECONOMICS

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The impact of specialist firm acquisitions on market quality ☆

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Received 27 November 2000; accepted 15 November 2001

Abstract

Acquisitions among New York Stock Exchange specialist firms can increase specialist firm size, capitalization, and market concentration, and thereby affect the market quality of the stocks they trade. We find that while traded stocks show significant improvement in several market quality measures following acquisitions, similar changes are evident in matched control stocks not involved in acquisitions. We conclude that specialist firm acquisitions either do not improve market quality, or improve market quality, but competitive and other pressures (resulting partly from the acquisitions themselves) force improvements in market quality for control stocks also. Either interpretation implies that specialist acquisitions have not had deleterious effects on market quality.

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JEL classification: G14; G19; G34

Keywords: Specialists; Mergers; Acquisitions; Market quality; Trading costs

1. Introduction

Acquisitions among New York Stock Exchange (NYSE) specialist firms have changed the structure of the U.S. listed-equity business dramatically over the last

☆The authors thank Jeff Bacidore, Robert Battalio, Hank Bessembinder, Robert Jennings, Andrew Spieler, colleagues at University of Cincinnati and Louisiana State University, seminar participants at the 2000 Western Finance Association Meeting and the 2000 Financial Management Association Meeting, and especially an anonymous JFE referee for helpful comments.

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PII: S0304-405X(02)00153-8

several decades. Stoll (1985) reports a reduction in the number of NYSE specialist firms from 230 in 1933 to 59 in 1983. The *Wall Street Journal* (July 2, 1992) reports that an additional 21 specialist firms were acquired between the October 1987 stock market crash and June 1992. This reduction has continued, leaving only eight NYSE specialist units in December 2001. David Humphreville, director of the NYSE Specialists Association, speculated that further consolidation to three or four specialist units would still be "workable" at the exchange (*Traders Magazine*, February 1, 2000).

Consolidation among specialist firms is not unique to the NYSE. Following the multiple listing of blue-chip options in August 1999 and the ensuing competition among option market specialist firms, spreads and specialist firm profits have fallen in these markets.[1] Financial press reports indicate that as a result "most, if not all, small- to medium-sized specialist firms are interested in selling their businesses to major trading firms" (*Dow Jones News Service*, July 5, 2000). Decimalization in equity and option markets also hastens consolidation via pressure on spreads and market-making profits (see e.g., Chakravarty et al., 2001). An official of a large market-making firm claims that tighter spreads on Nasdaq resulting from decimalization "will mean the mid-level market makers will be in trouble" (*Traders Magazine*, January 1, 2001).

As with acquisitions in any industry, the effects on consumers can be positive, negative, or zero. Specialist firm acquisitions potentially result in larger, better-capitalized, and better-diversified specialist units that are less risk-averse and better able to exploit scale economies and technological improvements. Theoretical and empirical analyses in the microstructure literature imply that these changes can both reduce the inventory management and order processing costs specialists face and improve their ability to provide price stability and increased depth. In a competitive market, specialist firms would pass on cost savings and other improvements in market quality to consumers. Throughout the paper, we adopt the perspective of liquidity demanders when we discuss changes in market quality for consumers or investors. Of course, improvements in market quality for liquidity demanders (e.g., tighter spreads and greater depth) can make competing liquidity suppliers (e.g., limit-order traders and institutional investors) worse off.

Conversely, specialist firm acquisitions can potentially increase specialist firm market power and reduce competition to a degree that allows them to increase their economic profits by increasing trading costs or reducing other dimensions of market quality. Acquisitions can also result in a stock being traded by a new specialist employee lacking expertise in detecting informed order flow for that stock. Thereby adverse selection costs can increase. Adverse selection costs can also increase if acquisitions increase ownership diffusion, which weakens incentives to detect informed order flow (Coughenour and Deli, 2002). Another potential negative effect of specialist firm acquisitions is increased systemic risk, in which the failure of a large specialist firm could have harmful market-wide effects. Citing concerns about systemic risk, the NYSE increased specialist capital requirements effective October

[1] See the SEC Special Study: *Payment for Order Flow and Internalization in the Option Markets*.

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