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# Local market makers, liquidity and market quality ☆

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**Abstract**

We examine the role of geographically proximate (local) market makers in providing liquidity and improving the quality of a dealer market. Firms with active participation of local dealers enjoy lower quoted and effective spreads, as well as more informative prices. The beneficial effects from local market makers are not confined to a few "top" local dealers and they cannot be attributed to their participation in the firm's IPO syndicate or industry specialization. Further, we find that days with aggressive bidding from local market makers relative to their non-local counterparts are associated with significant positive abnormal returns, consistent with local market makers possessing information advantages. In summary, our results suggest that the information advantages of local market makers may be a contributing factor to the reduction in the cost of trading.
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## 0. Introduction

A unique feature of a dealer market such as the NASDAQ stock market is the presence of multiple market makers. With multiple dealers, features of market structure such as the

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total number of dealers, degree of dealer concentration, and the market share of the dominant dealer have been shown to play an important role in the determination of the bid-ask spread.[1] The presence of multiple dealers also raises the possibility that dealers differ in their characteristics, with these differences impacting liquidity and cost of trading.

In this paper, we examine the geography of market makers and study whether differences in location affect their market making activities, and the resulting trading costs for these stocks. NASDAQ dealers are geographically dispersed: approximately 61% of these market makers are not located in New York City and about 33% are not located in an urban area.[2] Such geographic dispersion of dealers implies that some dealers are located close to the firms in which they make a market. We study whether proximity of dealers, and their active participation in market making, is a non-trivial feature of the market microstructure of stocks, and has an impact on liquidity and market quality.

Why does the location of dealers matter for the firms in which they make a market? Recent literature on geography points to two potential effects that geographic proximity may have on a dealer's market making decisions. First, several studies find that retail investors bias their portfolio towards geographically proximate or local firms.[3] A similar bias towards local stocks is also seen in the portfolios of institutional investors. This implies that a large fraction of the trading volume in a stock originates locally and is likely to flow to the local market maker. Indeed, Schultz (2003) documents that market makers in the same state as the firm account for a large fraction of the firm's trading. The local market makers' access to a potentially large and predictable order flow is likely to have a significant impact on their quoting and trading activities.

Second, there is also increasing evidence that geographic proximity may lead to information advantages. These information advantages have been shown in many diverse situations like bank lending, accuracy of analyst forecasts, and acquisitions.[4] If geographic proximity is associated with information advantages, then local market makers are likely to have superior information relative to their non-local counterparts. Such information advantages of local market makers could arise if they know their client base well, or are knowledgeable about whether or not certain orders are informed. In addition, through their social, civic, or business interactions with managers and employees of local firms, market makers may have better information about these firms. Their access to detailed coverage of regional business by local media as well as interactions with local financial intermediaries, like banks, may also give them information advantages over other market makers.

If easy access to order flow reduces dealers' inventory risks, and information advantages associated with location alleviates their potential adverse selection losses to informed traders, it is natural to expect local dealers to be more aggressive than their non-local counterparts in making a market in nearby firms. Therefore, firms that attract active local

[1]Refer to Christie and Schultz (1994), Kandel and Marx (1997), and Dutta and Madhavan (1997) among others for the nature of price competition. See Ellis, Michaely, and O'Hara (2002) for the role of dominant market makers, and Wahal (1997) and Schultz (2003) for the effect of number of dealers and dealer concentration.

[2]Urban areas are the Metropolitan Statistical Area (MSA) that includes the ten largest cities in the 2000 census.

[3]See Coval and Moskowitz (2001), Grinblatt and Keloharju (2001), Huberman (2001), and Ivkovich and Weisbenner (2005).

[4]See Hau (2001), Petersen and Rajan (2002), Degryse and Ongena (2004), Malloy (2005), Bae, Stulz, and Tan (2008), Kang and Kim (2008), and Kedia, Panchapagesan, and Uysal (2008) among others in this growing literature.

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