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Auction Markets, Dealership Markets and Execution Risk

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Abstract

Dealers are suppliers of liquidity; in this respect their role is similar to that played by speculators in auction markets. However, dealers are a special kind of speculator, because of the many obligations and privileges conferred upon them. The most obvious constraint on dealers' behaviour is their obligation to quote firm prices publicly; this implies that, in contrast with what happens on auction markets, traders are insured against execution risk, i.e., the risk of finding few or no counterparty to trade. The normative issue then is: when is it efficient for customers to buy insurance from dealers rather than bearing execution risk themselves? In our model the relevant condition is that dealers must be sufficiently less risk-averse than their customers. The dealership market is superior if dealers are risk-neutral and customers are risk- averse, while it is dominated by the auction market if dealers have the same degree of risk aversion as their customers. There is also an intermediate region of parameter values where the comparison between the two systems is ambiguous: if the fundamental risk of the security is low, the dealership mechanism dominates the auction, while for high-risk securities the reverse is true.

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