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Island Tides: Exploring Ecn Liquidity

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Abstract

The introduction of the Order Handling Rules and Regulation ATS by the U.S. Securities and Exchange Commission has had a major impact on the Nasdaq market. In particular, the rise and success of electronic communication systems (ECNs) is a direct outcome of these regulatory changes. This paper investigates the behavior of intra-day liquidity and trading on one of the most successful new market participants, the Island ECN. Using limit buy and sell order and time and sales data collected from Island's website, we find strong intraday patterns in trading volume and number of trades executed as well as market depth and price impact, our measure of liquidity. We also find that market quality on Island is far better during the hours when Nasdaq is open, and that after hours trading volume is negligible, mainly because of lack of liquidity. These findings indicate that ECNs strongly depend on the larger Nasdaq system. For example, the number of orders on the book increase and the price impact declines dramatically when Nasdaq opens. The reverse occurs at Nasdaq's close. We show that trading activity increases with (intra-day) volatility and available depth, and is negatively related to liquidity. We also find evidence of commonality in liquidity on Island.

JEL Classification: D40, G10

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