Miscellany

Volume Discovery: Leveraging Liquidity in the Depth of an Order Driven Market

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Abstract

Electron   ractice for
trading s   address the
needs of   e-counter
markets   quantity
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We prop   ' introduces
the new   ook. The
volume   parameters
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Show Purpose

For large orders, Volume Discovery leverages already existent liquidity to benefit block trading by increased likelihood of execution and reduced opportunity costs. For all orders, Volume Discovery promotes the integration of OTC markets and order book trading in order to improve liquidity while protecting price/time priority.

ACKNOWLEDGEMENT

Notes

1. As Nasdaq was traditionally a dealer market, dealers' quotes along with their identities were displayed on Nasdaq screens. Execution was not automated, trades had to be ex   ectNet
order rou   Nasdaq
introduc   ectronic
order bo   ealers'
identitie   ontage
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understa   ity to show
the   asdaq
enable   tifier 'SIZE' is
displaye

2. This t   order might
face whe   n the scope
of a dea   oy the
dealers,   the order
(delay due to non-automated execution).

3. In the US, however, the price and time priority rule is not as widely accepted, which is partly explained by the advent of decimal pricing in 2001. The subsequent decrease in the minimum tick size made penny-jumping (stepping ahead the best bid or offer by improving it by one cent) more attractive. This, in turn, might deter liquidity providers from exposing their trading interest in an open order book (SEC 2004: 11166).

4. An iceberg order peculiarity regards to time priority, which is lost whenever the visible part is fully executed. Then, the visible part is 'refilled' from the remaining volume, and the new peak receives a new timestamp which eventually leads to a loss of time priority.

5. See D'Hondt et al. (2003: table 4).

6. It must be noted that the data set used by Pardo and Pascual (2003) does not include hidden orders flagged as such. Instead, the authors operate with publicly available order book information, whereas they compare reported executions with the order book information available for the respective execution time. On this basis, the existence of hidden orders is reconstructed. One assumption underlying this methodology is that the findings 'are conditional on the implicit assumption that the sub sample of executed iceberg orders is representative of the whole sample of iceberg orders submitted' (Pardo and Pascual 2003: 14).

7. figure   er cent of total liqu

8. The tr   ted volume. In terms   n Xetra is about 1(

9. Withi   asis of naïve aver   he basis of the resp   volume class amounte   point out the differenc   a fair proxy for the u

10. An e   will be presente

11. This parameter is in addition to (and not to be confused with) the minimum volume for an iceberg order.

12. Harris (2003: 323–7) discusses four problems of block initiators in executing large order sizes: Latent demand, order exposure, price discrimination and asymmetric information. Addressing these problems reflect block initiators key requirements in trading. Whereas the problems of price discrimination and asymmetric information are often in the nature of large order sizes and hardly solvable at all, Volume Discovery addresses the problems of latent demand and order exposure. The latent demand problem refers to high search costs for block initiators to find a matching counterparty. Volume Discovery addresses this problem with the simultaneous double exposure of volume orders within a single liquidity pool. The order exposure problem refers to the increased market impact costs that block initiators can expect by unintended information spill over if they expose their large trading interest to other market participants. Volume discovery addresses this problem as volume orders are not disclosed to the market with their full size in the order book.

13. NYSE Rule 127 (Block Positioning) facilitates public limit orders on the Floor to participate in block crossing transactions at the clean-up price if the crossing shall take place outside the prevailing quote (NYSE 2005).

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