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Applying Pricing Engineering for Electronic Financial Markets

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Abstract

Due to the demutualization of exchanges, the business case of operating an electronic financial market has become even more important. Specifically, it is vital to design pricing incentives for the provision of order flow and thereby to assure market liquidity. The paper will introduce the concept of pricing engineering for electronic financial markets. Based on an analysis of environmental factors and the objectives of the market operator, a focus will be laid on the implementation of fee structures that include liquidity incentives. The concepts were implemented in the context of a new electronic market, the Dubai International Financial Exchange (DIFX). The project will be described as a case study for the practical realization of the pricing engineering approach.

 Keywords: [exchanges](#) [fee schedule](#) [liquidity](#) [market microstructure](#) [transaction costs](#)

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Notes

1. In the following the terms member/market participant refer to the intermediaries (banks or brokers) that are admitted to trading on the exchange, whereas the term customer refers to the private or institutional end customers (i.e. the indirect customers of the exchange and the direct customers of the intermediaries).
2. As pricing engineering for electronic markets does not yet appear in the academic literature, we aligned our approach with the one found in (Burchill and Fine 1997) where 'Concept engineering is a structured process, with supporting decision aids, for developing product concepts by a product development team.'
3. It should be noted that exchanges also compete vertically in the context of order internalization by brokers (see, e.g., Gomber and Maurer (2004)). This will not be addressed any further here.
4. A basis point represents 0.01%.
5. US exchanges charge on a per share basis due to historically grown structures.
6. It has to be kept in mind that there is a one-to-many relationship between orders and trades (1:N), i.e. one order can be partially executed and result in one or in a multitude of trades.
7. They are named, e.g., Designated Sponsors in case of Deutsche Börse, Market Makers in case of the LSE and Nasdaq or Liquidity Providers in the case of Euronext.
8. In contrast to natural liquidity that results from trading interests, the term artificial liquidity refers to liquidity that is provided due to a contractual commitment between intermediaries (liquidity providers) and the market operator.
9. Costs induced by the trade itself and the market conditions at the time of the transaction are referred to as implicit (Perold 1988).

10. Non-marketable limit orders are orders with a limit below the best ask (in case of a buy order) or with a limit above the best bid (in case of a sell order), i.e. these orders are not immediately executable and therefore are shown in the order book. In contrast, marketable orders are either market orders or limit orders that are immediately executable.

11. Technically the differentiation between those types of orders can be realized by using the time stamps of the orders participating in a trade. The order that was inserted earlier is the non-aggressor order, the order with the later time stamp is the aggressor order.

12. For background information on the establishment of the DIFX see: <http://www.difx.ae>. In December 2006, the DIFX had 17 members and 16 instruments listed.

13. Exchanges included: Dubai Financial Market (DFM), Abu Dhabi Securities Market (ADSM), Muscat Securities Market (MSM), Kuwait Stock Exchange (KSE), Tadawul Stock Market, Bahrain Stock Exchange (BSE), Doha Securities Market (DSM), Cairo and Alexandria Stock Exchange (CASE).

14. For instance, eBay's PowerSeller programme grants benefits to customers upon meeting certain activity criteria (eBay 2007).

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