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 cannot be attributed to their participation in the firm's IPO syndicate or industry specialization, and this local effect is mostly evidenced in firms with information problems such as small firms, non-urban firms and firms with high PIN values. 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.

JEL classification: G14; G19; G24

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