Liquidity improves when market makers avert adverse selection from fast arbitrageurs.

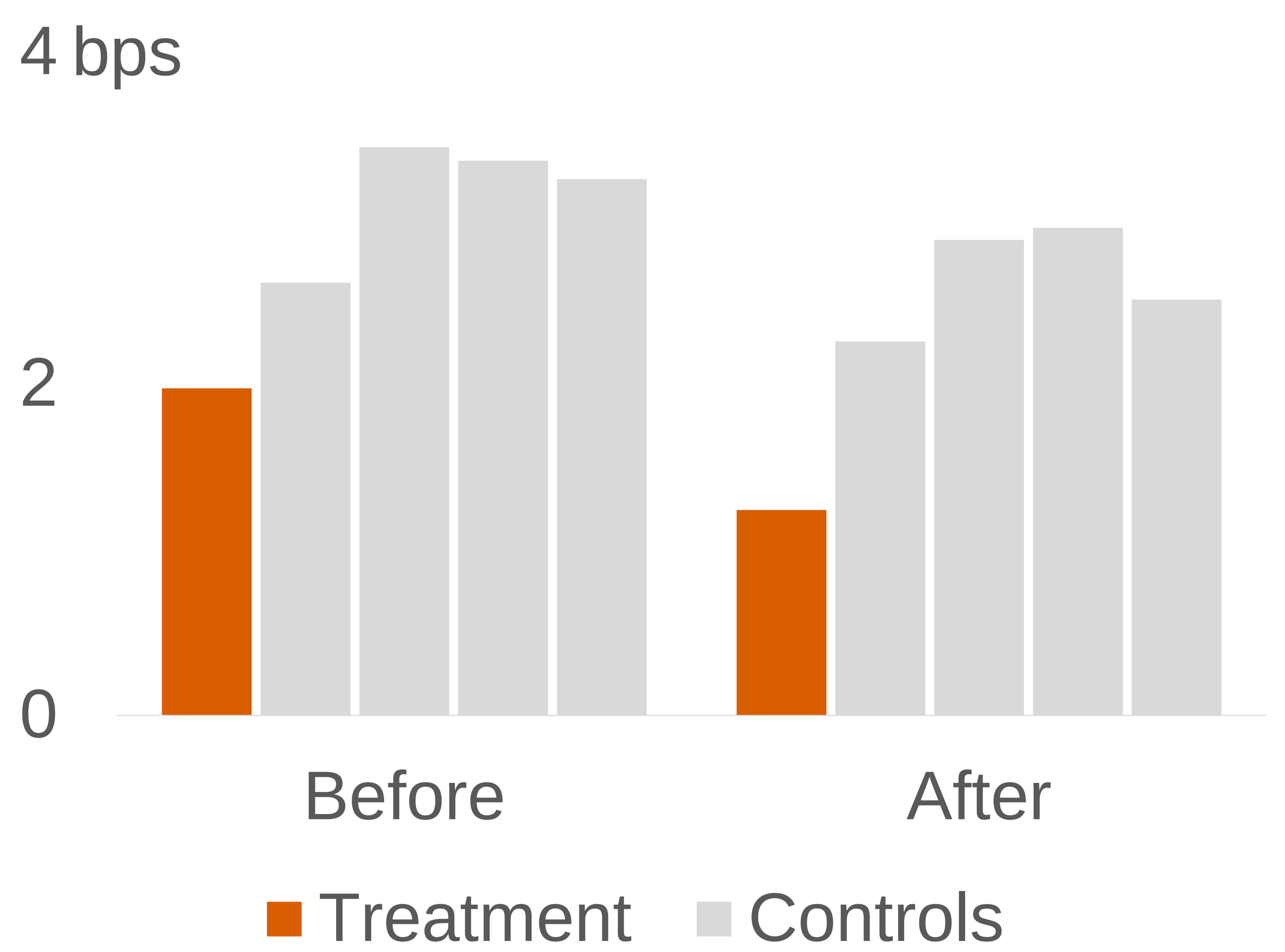

Fig 1. Adverse selection costs (plotted) due to fast arbitrage declined by **37%** on the treated exchange while quoted spread declined by **12%**.

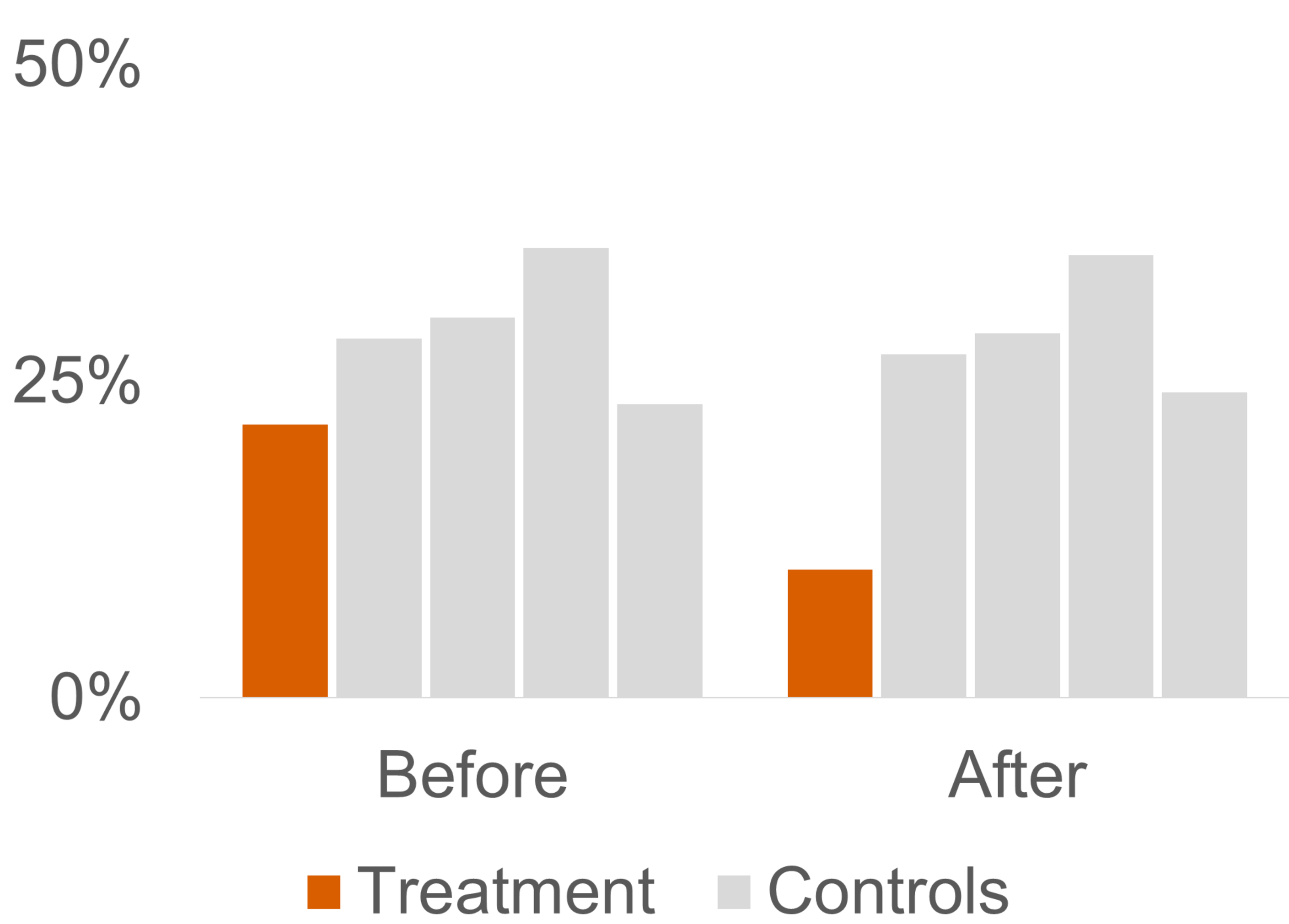

Fig 2. Liquidity taken by fast trading firms declined from 21% to **10%** after the ban restrained fast arbitrageur(s).

Introduction

- Fast arbitrageurs snipe stale quotes before market makers can cancel
  - Adds adverse selection costs
  - Discourages liquidity provision
- Curbs on fast arbitrage boost liquidity

Methods & Data

- DiD with stock, day, and venue FEs
- -/+4-week around the ban started
- Nasdaq Stockholm 30 Index stocks
- Quotes on 5 lit exchanges
- Trades with IDs of trading firms

Results

- Adverse selection and liquidity costs declined significantly
  - Adverse selection cost: **-34%**
  - Quotes spread: **-86%**
  - Effective spread: **-57%**

Discussion

- Spillover effects on other exchanges
- Generalization issues of the treatment
  - Small exchange
  - Unique market design
  - Only 1 fast arbitrageurs affected

Market Liquidity after Banning Aggressive Proprietary Trading

Chengcheng Qu
Stockholm Business School, Stockholm University
chengcheng.qu@sbs.su.se

Stockholm University