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THE POST-REFORM BID-ASK SPREAD DISPARITY BETWEEN NASDAQ AND THE NYSE

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Abstract

We report further evidence of the difference in execution costs between Nasdaq and the NYSE before and after the 1997 market reforms. We find that informed trading costs are consistently higher on Nasdaq both before and after the reforms. In the pre-reform period the Nasdaq-NYSE disparity in bid-ask spreads cannot be completely attributed to the difference in informed trading costs. However, in the post-reform period the spread difference between these two markets becomes insignificant with the effect of informed trading costs controlled. Our findings are consistent with the contention that the reforms have largely reduced noninformation trading costs and dealers' rents.

JEL Classification: G1

I. Introduction

Auction markets such as the New York Stock Exchange (NYSE) are order driven, whereas dealer markets such as Nasdaq are mainly quote driven. Which market is more efficient thus becomes an issue of great concern for researchers, practitioners, and regulators. A host of studies compare trading costs between dealer and auction markets. It is generally found that bid-ask spreads or execution costs are significantly higher on Nasdaq than on the NYSE. Researchers debate whether Nasdaq bid-ask spreads are competitive enough to reflect market-making costs. Christie and Schultz (1994) find that Nasdaq dealers avoid odd-eighth quotes. This evidence is interpreted as consistent with tacit collusion, due to which bid-ask spreads are inflated above the competitive level. Moreover, Huang and Stoll (1996) and Bessembinder and Kaufman (1997) contend that higher spreads on Nasdaq cannot be attributed to informed trading costs.

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