Summary of the Research Project Proposal

Are Designated Market Makers Effective Liquidity Providers?

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Many financial markets have designated market makers (DMM) who are supposed to play a crucial role in the provision of liquidity. The objective of having DDMs is to provide liquidity at all times, including stress periods. In this project, we investigate the role of designated market makers in the Milan stock market. In Milan, the rules governing the DMMs were tightened recently and they now are required to quote two way prices (buy and sell) at a maximum bid-ask spread. We have detailed data on the involvement of the DMM in quoting and trading for the period before and after the introduction of these so-called executable orders.

This data allows us to investigate a number of relevant questions. The first is the intraday performance of DDMs as liquidity providers. Subquestions here are whether DMM offer competitive quotes? Do they adequately increase depth at the top of the LOB? Do they contrast building imbalances or do they just step out of the market when the activity of liquidity provision becomes too risky? Do they change their quoting strategy when volatility increases? What are DMM profits? Are they consistent with the lump sum they receive for their market making activity? The second question is the effectiveness of the introduction of executable quotes. Has the role of DDMs as liquidity providers substantially changed after the introduction of two sided quotations?

The results of this project shed light on the relevance of designated market makers in financial markets. This is relevant both for regulators who design the rules under which DDMs operate, as well as for practitioners whose execution costs and execution risks are potentially mitigated by the presence of DDMs.