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Biography

- Prof. H. Kent Baker is University Professor of Finance at the Kogod School of Business, American University in Washington, DC.
- He is the author/co-editor or editor/co-editor of 24 books including several textbooks.
- Professor Baker has also published more than 250 journal articles, monographs, book chapters, and proceedings as well as 350 book reviews and abstracts.
- Much of his research is empirical and published in peer-reviewed academic journals

Journals include:

- Journal of Finance
- Journal of Financial and Quantitative Analysis
- Financial Management
- Financial Analysts Journal
- Journal of Portfolio Management
- Journal of Financial Research
- Financial Review
- Harvard Business Review
- Journal of Accountancy

- He has had consulting and training experience with more than 100 organizations.
- He currently serves on six advisory or editorial boards.
- Professor Baker received a B.S.B.A. from Georgetown University; an M.B.A., M.Ed., and D.B.A. from the University of Maryland, and M.S., M.A., and two PhDs from American University.
- He also holds CFA and CMA designations.

Research Interest

His research interests include:

- Survey research
- Investor behavior
- Financial psychology
- Market microstructure
- Dividend policy
- Mutual funds

Market Microstructure

- Market Microstructure is the process by which securities such as stocks are traded.
- For a stock market to function properly, a structure is needed to:

1. Facilitate the placing of orders.
2. Speed the execution of the trades ordered.
3. Provide equal access to information for all investors.

- It is the study of the process and outcomes of exchanging assets under explicit trading rules

- Analysis of how specific trading mechanisms affect the price formation process.
- Trading mechanism: set of rules governing the exchange of financial assets (stocks, derivatives) or foreign currencies in a market.

Need for market microstructure

- Tries to answer how prices are formed in the economy.
- Market microstructure has a profound impact on the real world – on traders, broker/dealers, exchanges, regulators, and policy makers alike.

Organization of Financial Markets

- Market player
  - **Brokers:** transmit orders for customers, act as conduits for the customers' orders. Involved only in interdealer transactions (FX market) =⇒ pure match makers (connect dealers).
  - **Dealers:** trade for their own account or also facilitate customer orders (broker/dealer).
  - **Market makers:** (specialists): quote price to buy or sell. Generally take a position in the security =⇒ dealer function.

- **Orders:**
  - Orders are instructions that traders give to the brokers and exchanges that arrange their trades.
  - They specify:
    - security to be traded,
    - how much to trade,
    - whether to buy or sell,
    - Terms
  - They may also specify:
    - their validity
    - their execution time

- whether they can be partially filled or not
- Orders affect the profit from trading, transaction costs, and the liquidity.
- **Major trading issues**
- Liquidity
- Transaction Costs
- Informative Prices
- Volatility
- Trading Profits

Forces affecting the structure of markets

- Demand for trading
  - Liquidity trading
  - Information trading
  - Noise trading (Black (1991))
- Order processing costs
  - Information system
  - Order routing systems (e.g., SuperDOT)
  - Order execution system (e.g., SuperMontage)
  - Clearing and Settlement

- Technology and automated trading
  - Resistance/vested interests (e.g., NYSE floor community!)
  - Block traders
- Risk bearing
  - Inventory risk
  - Payments risk
- Institutionalization
  - 50% of volume is institutional traders

- Free trading options
  - Stale limit orders
  - Stale quotes
- Information trading
  - Liquidity traders lose
  - Informed traders need to be compensated for research
- Anonymity, Reputation, Transparency
  - Disclosure of trades and quotes
  - Delayed disclosure
  - Upstairs facilitated trade
  - Reputation through repeated trading

Market structures

- The trading rules and the trading systems define a market's market structure.
- Call markets versus continuous markets.
  - Call markets allow trades only when the market is called (rotation among securities).
  - Continuous markets allow trades anytime during regular trading hours.
  - Hybrids of course exist (NYSE, the LSE and soon Nasdaq)
  - Which one would you prefer, and why?

- Trading hours.
  - Most markets limit their regular trading hours.
  - Should markets be open around the clock?

Market information systems

It is of utmost important that orders are not lost and that order instructions are understood.

  - Ticker symbols
  - Order routing systems
  - Order presentation systems
  - Messaging systems

- The information created by trading is valuable.
- Market data systems report trades to the public
- Broadcast services
  - Price and sale feeds
  - Ticker tapes
  - Quotation feeds

- Transparency is a key feature of markets.
  - Ex ante vs. ex post transparency

Market maker obligations

- Provide quotes during trading hours
- Offer “best execution”
- Report trades in a timely manner
- Fair communication
- No churning

Thank You..!

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