

Less Is More

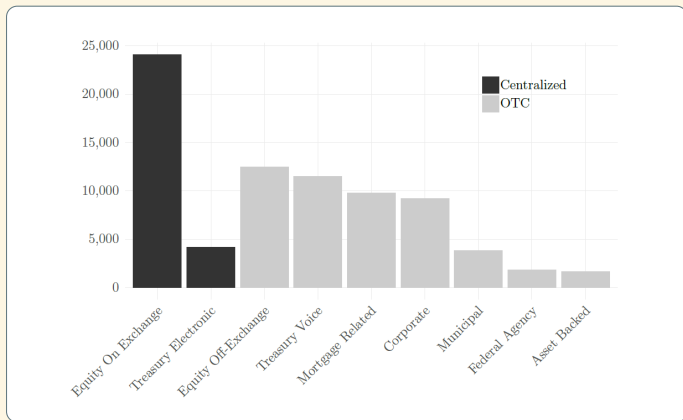
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PRESENTATION AT THE AUTORITÉ DES MARCHÉS FINANCIERS

Background and Motivation

SIZE OF CENTRALIZED AND OTC MARKETS



Security supply outstanding in the U.S. in 2018, Billions of 2019 USD (Weill, 2022)

STYLIZED FACTS

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- CDS on electronic platforms: customers on average query **4.1** dealers, while the upper bound is **5** on Bloomberg and ∞ on Tradeweb (Riggs et al., 2020)
- Canadian gov't bond on CanDeal: **40%** of auctions did not exhaust the allowed **4** dealers (Allen and Wittwer, 2021)
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⇒ Why not contact more dealers?

EXPLANATIONS FROM THE LITERATURE

- search cost or contact cost
- information concerns
- customer-dealer relationship

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 - ▶ e.g., Stigler (1961)
 - ▶ maybe for conventional OTC trading
 - ▶ less plausible for electronic platforms
- information concerns
 - ▶ reaching out to more dealers
 - leaks information: Burdett and O'Hara (1987); Baldauf and Mollner (2022)
 - hides information: Kondor and Pintér (2022); Brogaard et al. (2022)
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- customer-dealer relationship
 - ▶ Bernhardt et al. (2005): relationship = threat to switch dealer
 - ▶ Desgranges and Foucault (2005): relationship = uninformed trades
 - ▶ Hendershott et al. (2020): relationship = an exogenous utility flow
 - ▶ ...
 - ▶ “relationship” is not an answer—need to understand the mechanism

Less-Is-More Mechanism

LESS-IS-MORE MECHANISM IN A NUTSHELL

Two key premises

- Dealers exert costly “*pre-trading* efforts” to provide liquidity
// *E.g.: labor, inventory, margin, clearing, ...*
- Dealers are aware of “competition” from others
// *The customer might be contacting many other dealers*

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A novel effect:

contact fewer dealers \Rightarrow dealer competition \downarrow
 \Rightarrow marginal revenue \uparrow
 \Rightarrow more effort to provide liquidity

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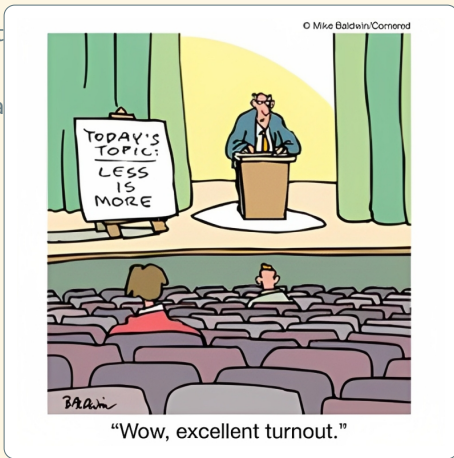
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Equilibrium tradeoff

- conventional **matching and competition benefits**: more dealers
- novel **less-is-more**: fewer dealers

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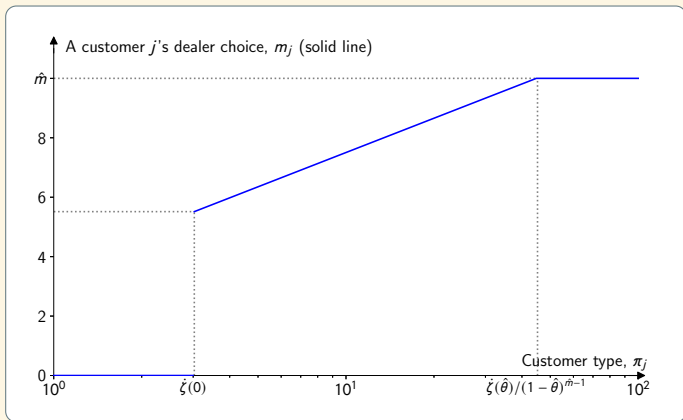
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Determinant of customer's optimal dealer choice: **competition elasticity**

- The higher the competition elasticity is, the fewer dealers a customer contacts.
- Empirically, customers do not exhaust all dealers, suggesting high competition elasticity.

CUSTOMER'S OPTIMAL DEALER CHOICE



Electronic platform design issues

TWO DESIGN CHOICES: OUR RECOMMENDATIONS

Should the platform inform dealers of the competition they are facing?

- MarketAxess: customer's dealer contact is not revealed (O'Hara and Zhou, 2021)
- Bloomberg and Tradeweb SEFs: customer's dealer contact is revealed (Riggs et al., 2020)

How many dealers should the customer be allowed to query?

- MarketAxess and Tradeweb SEF: unrestricted
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- CFTC "MAT" mandate for SEF: at least 3

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⇒ Should be capped, but not one-size-fit-all; contingent on trade size

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- Dealers face much more competition and engage in more severe “arms race” in providing pre-trading services

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Corollary (Dealer competition observability)

Welfare is higher when when customers' dealer contact is revealed to dealers.

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If a social planner can mandate dealer contact, she maximizes the probability of trading

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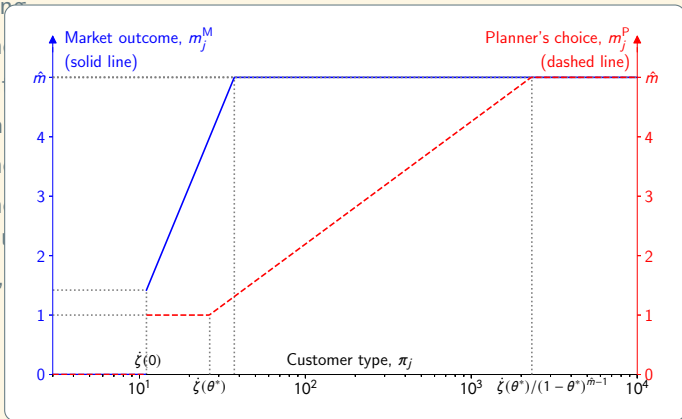
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Corollary (The number of dealers to maximize welfare)

*The optimal number of dealers one can contact should be **contingent on trade size**: A customer with a larger order size should be allowed to query more dealers.*

Conclusion

CONCLUSION

- Why do customers not contact as many dealers as available?
 - ▶ Less-is-more: giving dealers exclusivity to induce better service
- A model to nail the key determinant: competition elasticity
- Two applications in electronic platform design
- Future research questions
 - ▶ Coexistence of traditional OTC markets and electronic platforms
 - ▶ Competition between platforms

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