

On Market Makers' Contribution to Trading Efficiency in Options Traded On an Electronic Stock Exchange

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Abstract

In late 2002, the Hauser Committee recommended that market makers be permitted to operate in the TASE's computerized option market. In response to this recommendation, the TASE decided to encourage market making in shekel-euro options by offering direct remuneration to market makers in exchange for obligations they would assume. These obligations include the obligation to enter quotes for sell and buy orders. Market makers began to operate in March 2004. This event creates laboratory-like conditions that allow us to examine market makers' contribution to option liquidity and trading efficiency, in a stock market where trading is electronic and the trading terms of market makers are identical to those of other players on the market.

Main findings include: (1) Liquidity increased. Trading volumes in options increased by 60% and buy-sell spreads dropped by 35%. (2) As a result, efficiency of trading in euro-shekel options increased. We found that deviations from a parity of call and put option prices declined significantly by 12% and the well-known asymmetry in option prices (skewness) declined by 30%. We also found that these improvements in trading were achieved even though the volume of trading involving market makers accounted for only 15% of the total trading volume. Based on these findings, we conclude that the presence of market makers in itself has a broader effect than the volume of their trading because they promote trading activity through others, in general. These findings point to the need to integrate market makers in the TASE in securities characterized by relatively low marketability.

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