T R A D I N G

Over-the-Counter Markets

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This paper lays out a theory of asset pricing and market making based on search and bargaining. We show how search-based inefficiencies affect prices through equilibrium allocations and through the effect of search on agents' bargaining positions, that is, their outside options based on their ability to trade with other investors or market makers.

The model that we present here can also be viewed as one of imperfect competition, for example, in specialist-based equity markets. In particular, the model shows that even a monopolistic market maker may have a tight bid–ask spread if investors can easily trade directly with each other. This resembles the situation at the New York Stock Exchange.

However, on Nasdaq, a "phone market" with several dealers for each stock, it can be difficult for investors to find each other directly. Before the reforms of 1994, 1995, and 1997, it was difficult for investors to compete with Nasdaq market makers through limit orders. This may help explain why spreads were higher on Nasdaq than on NYSE.