Introduction

- Most trading goes through intermediaries. Mainly two types of trading.
  - Agency Trading: No inventory risk, earn commission.
  - Principal Trading: Take inventory, earn markup.
- The popularity of principal trading has been blamed for the crisis in 2008.

**Question:** What determines principal and agency trading?

**Puzzle:** Same intermediary, different execution method (principal/agency).
- Equities: almost all agency.
- Fixed income and currencies: almost all principal.

**Results**
- Agency trading is more likely 1) in markets with high turnover and good transparency and 2) when intermediaries have higher holding costs.
- Empirical evidence supports these predictions.

The Model

- All agents are risk neutral.
- Investors balance
  1) Higher holding cost by principal trading.
  2) Moral hazard of agency trading (thus need monitoring).

**Key:** Investors balance the additional holding costs associated with principal trading, and the above-market commission (to avoid moral hazard) in agency trading.

**Results**
- Agency trading is more likely
  1) In a transparent market.
  2) When turnover is high.
  2) When intermediaries have higher holding costs.

Empirical Evidence

**Transparency and Turnover**
- Cross-market comparison confirms our intuition.

Summary

- All intermediated trade executions can be done in an agency style, or a principal style. But there are dramatic differences across markets, even for the same intermediary.
- We propose a theory based on intermediary moral hazard and inventory cost to explain the variation of principal/agency trading.
- Cross market comparison confirms the prediction that agency trading is more likely with better transparency and higher turnover.
- Diff-in-diff test confirms the prediction on intermediary holding costs.