

## **Quote Setting and Price Formation in an Order Driven Market**

**T**his paper models quote setting and price formation in a non-intermediated, order driven market, and tests the model using transaction data on individual stocks in the Paris Bourse CAC40 index. In an extension of Foucault (1999) where investor share valuations for a security differ, we examine the impact of asymmetric information on posted bid and ask prices. Our primary objective is to analyze the determinants of the bid-ask spread in an order driven market and our main contribution is to test the empirical implications of the extended Foucault model. The theoretical model we present in this paper shows, and our empirical tests confirm, that the size of the inside spread in an order driven market is a function of differences in valuation among investors. As we will explain, our analysis in this regard may be viewed as an extension of Cohen, Maier, Schwartz and Whitcomb (1981) who demonstrate that a natural bid-ask spread exists in an order driven market because of the “gravitational pull” an already posted order has on a new, incoming order. The current paper also extends Handa and Schwartz (1996) who analyze the rationale and profitability of limit order trading, but who do not explicitly model a trader’s decision as to whether to place a limit order or a market order. **To read More ,please download the book. Puneet Handa Robert Schwartz Ashish Tiwari [Download This Book](#)**