

Limited Attention and the Allocation of Effort in Securities Trading

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Abstract

Limited attention has been analyzed in a variety of economic and psychological settings, but its impact on financial markets is not well understood. In this paper, we examine individual NYSE specialist portfolios and test whether liquidity provision is affected as specialists allocate their attention across stocks. Our results indicate that specialists allocate effort toward their most active stocks during periods of increased activity, resulting in less frequent price improvement and increased transaction costs for their remaining assigned stocks. Thus, the allocation of effort due to limited attention has a significant impact on liquidity provision in securities markets.

Substantial evidence suggests that humans are limited in their ability to process information and to perform multiple tasks simultaneously. Kahneman (1973) argues that this type of “limited attention” requires individuals to allocate their cognitive resources across tasks, so that attention spent on one task must reduce attention available for other tasks.¹ In this paper, we test whether limited attention affects the specialist’s ability to provide liquidity for securities listed on the New York Stock Exchange (NYSE).

Early work related to attention in the finance literature focused on the information available to investors. For example, Merton (1987) analyzes market equilibrium in a setting where investors know about only a subset of securities.² More recently, several theoretical and empirical studies examine the effects of attention allocation on financial markets and investor behavior. Peng (2005) illustrates that investors will optimally allocate their limited attention across sources of uncertainty to minimize total portfolio uncertainty. Peng and Xiong (2006) show that investors with limited attention will resort to simple decision rules, such as categorization, and these actions can explain well-documented patterns in asset return co-variation.³ Consistent with these theories, Huberman (2001), Huberman and Regev (2001), and Barber and Odean (2007) provide evidence that investors tend to focus on familiar or attention-grabbing stocks and that information may not be incorporated into prices until it attracts investor attention. While this research provides indirect evidence of limited attention, direct tests are scarce because it is difficult to measure attention and its allocation across tasks in financial market settings.

Market making on the NYSE provides an ideal setting for analyzing the effects of limited attention for several reasons. First, the NYSE features individual specialists who are obligated to provide liquidity for a well-defined set of securities. As a result, we can directly identify the set of securities across which the specialist must divide his attention. Second, we can measure factors that necessitate the allocation of attention across securities. We measure the degree of attention a specialist can provide to any stock as an inverse function of the trading activity and absolute returns of all other stocks in the specialist’s portfolio. Finally, because specialists provide an important source of liquidity through their participation in trading, the effects of limited attention can be identified using various liquidity measures. If limited attention forces a specialist to allocate effort across stocks, we expect his ability to provide

liquidity for a given stock to be negatively related to the attention requirements of other stocks in his portfolio, all else constant. We refer to this as the *Limited Attention Hypothesis*.

The Limited Attention Hypothesis is based on the assumption that individual specialists face time and processing constraints that limit their ability to monitor and process multiple orders simultaneously, particularly during busy trading periods. While limited specialist attention can affect all stocks, we expect the effects to be most evident for inactive securities for two reasons. First, specialists participate in a larger fraction of trades and provide a greater proportion of liquidity for inactive securities (see Madhavan and Sofianos (1998)). As a result, changes in specialist participation should be most apparent for these securities. Second, cost-benefit models of attention allocation suggest that agents will allocate attention in a manner that maximizes their total utility.⁴ Since specialists put more capital at risk when trading the most active stocks and derive a large fraction of their profits from these stocks (see Sofianos (1995) and Coughenour and Harris (2005)), we argue that they are less likely to divert attention from these securities.

We test the Limited Attention Hypothesis using intraday transaction data from TAQ combined with trading floor location data from the NYSE's specialist directories. Results from pooled time-series and cross-sectional regressions indicate that the rate and magnitude of price improvement decrease and bid-ask spreads increase and as the specialist's attention to other stocks at the panel increases. These results hold after controlling for the stock's own trading activity and return volatility, for firm fixed effects, for time-of-day effects, and for market-wide variation in liquidity and attention. Further tests indicate that the effects of limited attention are most evident for the least active stocks and are robust to alternative specifications and econometric techniques. Together, our results indicate that limited attention has a significant impact on liquidity provision in financial markets.

Our evidence is particularly notable given that several NYSE characteristics work to reduce the effects of limited attention. NYSE specialists are highly regulated and their performance with respect to liquidity provision is closely monitored. As a result, they have incentives to avoid attention problems. During unusually busy periods, specialists can increase capacity by calling on 'relief specialists' or additional clerks. In addition, specialist firms appear to allocate stocks to panels in a manner that reflects

attention limits. The most active stocks generally trade apart from one another and with fewer other securities, allowing specialists to maximize the attention paid to these stocks. Together, these factors may mitigate the potential effects of an individual specialist's limited attention. Nevertheless, we document a significant relation between limited attention and liquidity provision.

Our empirical work is related to three recent studies of individual specialist portfolios. Battalio, Ellul, and Jennings (2007) examine time-series changes in transaction costs, focusing specifically on changes in floor location. They find that specialists form cost-reducing relationships with floor brokers and that these relationships take time to develop following a reorganization of the trading floor. Our results provide additional evidence that the location of a security on the trading floor can influence liquidity provision. In cross-sectional analyses, Huang and Liu (2004) find that NYSE specialists subsidize the illiquid stocks in their portfolio and Boulatov, Hatch, Johnson, and Lei (2007) find that quote adjustment speeds depend upon the prominence of the stock within the specialist's portfolio. While our evidence is generally consistent with these two studies, we note that cross-sectional analyses of limited attention are difficult to interpret given the endogenous relation between stock characteristics and specialist portfolios. In contrast, our study focuses on the time-series covariation between liquidity provision and the activity of other stocks handled by the same specialist. This allows us to minimize the aforementioned endogeneity problem and to directly test whether variation in attention affects the specialist's ability to provide liquidity.

Although prior studies suggest that limited attention may influence investors' demand for liquidity in financial markets, our study provides the first direct evidence that limited attention influences the supply of liquidity. Specifically, we find that liquidity provision is significantly affected by the limited attention of market makers and the resulting allocation of effort across securities. These findings point to a potential but unexplored benefit of recent NYSE initiatives to automate a larger fraction of trading. Increased automation of trade executions may reduce capacity constraints and allow specialists to focus on those trades for which they add the most value. However, our analysis does not permit us to draw conclusions about the optimality of alternative market structures or to determine whether a reduction in

capacity constraints would result in lower transaction costs for the overall market. We argue only that market maker attention is limited and that the resulting effects are significant enough to be considered along with other costs and benefits of market design. While our tests are based on data from the NYSE, our findings may apply to other markets where dealers allocate attention across multiple securities.

The remainder of the paper is organized as follows. In Section I we discuss related literature and develop our main hypothesis. Section II describes the data and sample characteristics. In Section III we provide the main empirical tests of the Limited Attention Hypothesis. Section IV describes additional tests and robustness checks and Section V concludes.

I. Background and Motivation

A. The NYSE Trading Floor and the Role of the Specialist

Each security traded on the NYSE is handled by a single specialist who is responsible for making a “fair and orderly market” in the security. However, individual specialists are typically responsible for making markets in multiple securities. As of August 2002, there were seven active specialist firms on the NYSE trading at 19 trading posts and 357 trading panels. The number of securities traded at an individual specialist panel (including common and preferred stocks, warrants, trusts, and other structured products) ranged from one to 63. Throughout the paper, we refer to the stocks at a single panel as an individual specialist portfolio.⁵

The decision of assigning a security to an individual specialist involves input from the listing firm, the specialist firm, and the Exchange. Initially, stocks are allocated to specialist firms in accordance with the Exchange’s Allocation Policy and Procedures (see Corwin (2004)). During this process, the specialist firm identifies the individual specialist who will be assigned to the stock. Once allocated, reassignments of stocks across specialist firms are rare.⁶ However, reassignments of stocks within a specialist firm are relatively common and specialist firms have some flexibility in how they organize stocks across trading panels. Corwin (2004) finds that stock allocations to NYSE specialist firms reflect both performance and non-performance variables. Notably, since specialist performance influences future

stock allocations, specialists may be unwilling to set unusually wide quotes or avoid participation in the trading process for extended periods of time.

B. Market Making and the Limited Attention Hypothesis

An NYSE specialist can affect liquidity in several ways. First, the specialist is responsible for posting bid and ask quotes. At their discretion, the specialist can choose to either post quotes that reflect the liquidity in the limited order book or add liquidity by posting quotes that improve upon the limit book price or depth. Traditional microstructure models suggest that a market maker will set bid and ask quotes conditional on their level of inventory risk and the probability of informed trade.⁷ In addition, models of limit order markets suggest that limit book dynamics will depend on order arrival rates and the patience of traders (see Foucault, Kadan, and Kandel (2005) and Rosu (2006)). Notably, none of these models account for the possibility that individual specialists may be subject to limited attention.

The specialist also has a significant influence on liquidity through their role in executing trades at prices better than the quotes. As described by Petersen and Fialkowski (1994), the specialist can generally accomplish this in two ways. First, the specialist can ‘stop’ a market order, guaranteeing a price at least as good as the current quote. The specialist then attempts to fill the order at an improved price by matching it with a subsequent incoming order. At worst, the stopped order will be executed at the guaranteed price. Second, the specialist can participate in the trade directly by purchasing or selling from their own inventory at a price better than the posted quotes. Both cases require specialist attention, though only the second involves the direct participation of the specialist in the trade.

If specialists face attention limits, they may not be able to continuously incorporate information or act as a source of liquidity for all securities in their portfolio. During busy periods, specialists may be forced to allocate effort across the securities in their portfolio. If a specialist reduces the attention paid to a particular security, it is likely to affect liquidity in two ways. First, the specialist is likely to minimize their inventory and adverse selection risks by reducing or eliminating their participation in the posted bid-ask quotes. Second, a specialist facing binding attention limits will be less able to improve liquidity by

participating in trades inside the quotes or by stopping orders. Together, these arguments suggest that the specialist's ability to provide liquidity will be negatively related to the attention requirements of other stocks in his portfolio. We refer to this as the *Limited Attention Hypothesis*.

What factors determine how a specialist allocates effort? Given the intuition in Peng (2005), we expect a constrained specialist to allocate effort toward those stocks that have the greatest impact on his utility. In particular, we expect specialists to focus on those stocks that have the largest influence on their portfolio profits and risk. Given that specialists place the most capital at risk when trading the largest, most active securities, it is reasonable to expect that these securities have the greatest impact on specialist risk. In addition, the largest, most active securities account for the vast majority of specialist profits. For example, Coughenour and Harris (2005) find that roughly 82% of combined specialist revenue is derived from the 100 most active NYSE stocks. Thus, both profit and risk considerations suggest that specialists will allocate their attention toward the largest, most active stocks in their portfolio.

If specialists allocate attention toward the largest, most active securities, the attention devoted to the less active securities in their portfolio must be reduced. This suggests that the effects of limited attention should be most evident for small, inactive securities. The effects of limited attention may also have a greater impact on inactive securities because specialists provide a larger fraction of liquidity for these securities. Madhavan and Sofianos (1998), for example, report that specialists participate in 54% of share volume in the least active decile of NYSE stocks, compared to only 15% in the most active decile. Since small, inactive securities rely more on the specialist to supply liquidity, transaction costs for these securities will be tied more directly to specialist actions. In contrast, transaction costs for active stocks are more likely to reflect the actions of other traders and the liquidity in the limit order book.

II. Data and Sample Characteristics

To analyze the effects of limited attention within specialist portfolios, we must identify the NYSE floor location of each security, each day. To accomplish this, we use daily NYSE Specialist Directories from August 1, 2002 through October 31, 2002. For every NYSE-listed security, the directory identifies

the specialist firm assigned to the security, as well as the post and panel where the security trades on the NYSE floor. The number of securities listed in the directory (including all common and preferred stocks, warrants, and structured products) ranges from 3,599 on August 1, 2002 to 3,609 on October 31, 2002.

To refine the sample, we combine the Specialist Directory data with additional information from the Center for Research in Security Prices (CRSP). We start by identifying the sample of securities included in both CRSP and the NYSE Specialist Directory for the full sample period from August 1 through October 31, 2002. This provides an initial sample of 2,515 securities. We then restrict the sample to common stocks and ADRs (CRSP share code equal to 10, 11, 12, 30, or 31). This reduces the sample to 1,920 securities. Throughout the rest of the paper, we refer to these 1,920 securities as the “full sample,” and we use this sample to define the characteristics of individual specialist portfolios.

For all liquidity analyses, we focus on the subset of stocks that meet an additional set of price and trading restrictions. We remove stocks that experience a stock split during the sample period, stocks with an average transaction price during the sample period of less than \$3 or greater than \$200, stocks with an average transaction price during any 30-minute period of less than \$2, and stocks that trade in fewer than 800 of the 840 30-minute trading periods. These restrictions reduce the sample by 14, 125, 14, and 496 securities, respectively.⁸ We also remove 19 securities that either trade alone at a panel or have panel attention, as defined below, equal to zero for more than 26 periods. The restricted sample used in the regression analysis includes 1,252 NYSE-listed common stocks and ADRs.

For each security in the restricted sample, we estimate measures of price improvement and execution costs at 30-minute intervals based on intraday trade and quote data from the NYSE’s TAQ database. We define all liquidity and attention measures using only NYSE trades and quotes.⁹ For each transaction, let t denote transaction time, p denote transaction price, a denote the ask price, b denote the bid price, and m denote the bid-ask midpoint. To measure transaction costs, we define the quoted spread (qs_t) as $a_t - b_t$, the percentage quoted spread (pqs_t) as $100 \cdot qs_t / m_t$, the effective spread (es_t) as $2 |p_t - m_t|$, and the percentage effective spread (pes_t) as $100 \cdot es_t / m_t$. We then aggregate by taking a trade-weighted average across all trades during the 30-minute period.

Our hypothesis is motivated by the direct involvement of the specialist in the trading process. Although spreads are affected by the actions of the specialist, they may also be influenced by the placement of limit orders and the actions of other traders. To provide a more direct measure of the specialist's involvement in the trading process, we focus on trades that execute inside the quotes (or price-improved trades). Coughenour and Harris (2005) find that specialists participate in 66 to 70 % of trades that occur inside the quotes, compared to only 28 to 30 % of all trades. These results suggest that trades occurring inside the quotes are more likely to reflect the direct involvement of the specialist in the trading process and provide a useful means to assess the relation between limited attention and liquidity provision by the specialist. We calculate both the magnitude and the rate of price improvement. For each trade, the magnitude of price improvement equals the difference between the relevant quoted price and the transaction price, stated as either a dollar amount or a percentage of the quote midpoint. Specifically, the dollar magnitude of price improvement for a buy order equals $a_t - p_t$ and the percentage magnitude equals $(a_t - p_t)/m_t$. Price improvement measures for sell orders are defined analogously based on the bid price.¹⁰ We then aggregate by taking a trade-weighted average across all trades during the 30-minute period. The rate of price improvement equals the proportion of trades during the 30-minute period that occur inside the bid and ask quotes.

The choice of a 30-minute aggregation period is largely driven by the nature of our hypothesis. A 30-minute interval should be fine enough to capture periods during which the specialist becomes time-constrained and well-known intraday variation in trading activity and transaction costs (see, for example, McNish and Wood (1992)). Aggregating over higher frequency periods (such as 5-minutes) would result in many zero trade observations and noisier estimates of transaction costs for the less-actively traded stocks. Lower frequency aggregation periods (such as daily) would reduce the power of our tests by smoothing over intraday periods of intense trading.

The Limited Attention Hypothesis suggests that specialists allocate effort away from the least active securities and toward the most active securities. Following Coughenour and Harris (2005), we sort our sample into three subsets based on trade frequency; the 100 most active; the next 400 mid-active; and

the remaining 752 least active securities. Specifically, we categorize stocks based on their median trade frequency during the three month pre-sample period from May through July, 2002. Throughout the paper we conduct tests on the filtered sample of 1,252 securities and the trade activity subsamples.¹¹

Table I provides summary statistics for the filtered sample of 1,252 securities and the three trade activity subsamples. For each security, we first calculate the time-series mean of each variable. The table then describes the cross-sectional distribution of these time-series means. Across the full sample (Panel A), the average transaction price ranges from \$3.15 to \$121.73, with a mean of \$26.58. The average firm trades at least once in 837 of the 840 30-minute trading intervals, with an average volume of 65,000 shares or \$1.89 million per period and an average trade size of 780 shares. Trading activity ranges from a per period average of 5.8 trades and 1700 shares to 329 trades and 1.2 million shares.

[INSERT TABLE I HERE]

On average, 36.3% of NYSE trades occur inside the quotes and the rate of price improvement ranges from 15.2 to 54.8%. The average firm has a quoted bid-ask spread of 5.2 cents and an effective spread of 3.8 cents, reflecting price improvement of 1.4 cents. The average percentage quoted spread is 26.7 basis points (bps) and the average percentage effective spread is 19.4 bps, reflecting price improvement of 7.36 bps. The average magnitude of price improvement ranges from 0.41 to 5.57 cents and from 1.59 to 47.63 bps.

The results for the three trade activity subsamples (Table I, Panel B) illustrate the substantial cross-sectional variation in trading activity and liquidity. The most active stocks average 196 trades per period, while the mid- and low-activity stocks average 89 and 26 trades per period, respectively. Similarly, dollar volume drops from \$11.1 million per period for the most active stocks, to \$2.5 million for the mid-activity stocks and \$0.35 million for the least active stocks. The rate of price improvement ranges from 35.9% for the least active stocks to 39.1% for the most active group. In addition, the magnitude of price improvement ranges from 1.4 cents and 4.4 bps for the most active stocks to 1.5 cents and 8.9 bps for the least active stocks. In comparison, percentage quoted spreads range from 14.2 bps for the most active stocks to 33.2 bps for the least active stocks and percentage effective spreads range from

9.8 bps for the most active stocks to 24.3 bps for the least active stocks. The restriction of equal means across trade activity categories is easily rejected for all variables at the one % level.

Since our hypothesis centers on individual specialists, we provide summary statistics describing the NYSE trading floor and the composition of individual specialist portfolios. Table II provides a description of NYSE post and panel composition as of August 1, 2002. On this date, the trading floor included 19 active trading posts and 357 panels. Using the full specialist directory, the mean and median panel sizes are 10.1 and 9.0 securities, respectively, and panel size ranges from one to 63 securities. The four securities that trade alone at a panel on August 1 are Nortel Networks, CIT Group, and the SPY and QQQ exchange traded funds.¹² Of the 3,599 securities in the directory at the start of the sample period, 15% change trading posts and 27.8% change trading panels at some point during the sample period. This highlights the importance of identifying specialist portfolios on a daily basis.

[INSERT TABLE II HERE]

After excluding funds, REITs, Units, Trusts, and other structured products, we find that common stocks and ADRs trade at 331 different panels, with an average panel size of 5.8 stocks. Notably, the reduction in number of panels relative to the full specialist directory suggests that 26 panels trade no common stocks or ADRs. The largest panel now includes 21 common stocks and there are 11 securities traded at panels with no other common stocks. Of the 1,920 common stocks and ADRs in the sample, 17.6% change posts and 31.5% change panels at some point during the sample period.

The full distribution of panel size is illustrated in more detail in Figure 1. As suggested in Table II, the distribution of panel size in the full specialist directory (Panel A) is substantially skewed. The mode of panel size is nine and there are approximately 25 to 35 panels at each panel size from five to eleven. However, there are also numerous panels with more than 20 securities. Restricting the sample to common stocks and ADRs (Panel B) substantially reduces the skewness in panel size. The mode of panel size is reduced to five and there is only one panel with more than 20 securities.

[INSERT FIGURE 1 HERE]

For completeness, Table II also describes panel size in the price and trade restricted sample of 1,252 stocks. Of the 357 original panels, 312 trade at least one security from the restricted sample. The average panel includes four sample stocks and the largest panel includes 12 sample stocks. Of the 1,252 stocks in this sample, 17.3% change posts and 32.4% change panels during the sample period.

If limited attention is an important market making consideration, we expect NYSE specialist firms to assign their most active stocks to panels with few other securities. As an initial test of our hypothesis, we therefore examine the relation between individual stock trade activity and panel assignments on the NYSE floor. For each stock in our restricted sample, we calculate the average number of securities at its panel, the stock's average rank at its panel based on number of trades, and the stock's average proportion of trades and dollar volume at its panel based on the full sample of 1,920 common stocks and ADRs. For comparison, we also provide a description of panel size using the full specialist directory. To account for changes in panel composition over time, we estimate the rank and percentage of trade activity each 30-minute period and calculate an average for each stock across all periods.

Table III reports the cross-sectional means of panel characteristics for each of our three trade activity categories. Including all securities in the specialist directory, the most active stocks trade on panels with 7.9 securities, on average, while the least active stocks trade on panels with 13.0 securities. Counting only common stocks and ADRs, the most active stocks have an average panel size of 4.5, while the least active stocks have an average panel size of 8.0. Conclusions from panel ranks are similar. The most active stocks have an average panel rank of 1.2 and the least active stocks have an average panel rank of 3.8, where rank equals one if the stock is the most actively traded at the panel. We also find that active stocks account for a significantly larger proportion of trading volume at the panel, representing 68.0% of dollar volume and 58.1% of trades, on average. In contrast, the least active stocks represent only 11.2% of panel dollar volume and 13.2% of panel trades, on average. The restriction of equal means across trade activity groups is easily rejected for all variables at the one % level.

[INSERT TABLE III HERE]

The evidence in Table III is consistent with the hypothesis that specialist firms tend to place their most actively traded securities at smaller panels. We conclude that the observed allocation of stocks to panels provides *prima facie* evidence that specialist firms recognize the marginal costs associated with limited attention and effort allocation. In the following sections, we consider the significance of these costs in light of the fact that they may be reduced by the allocation decisions of specialist firms.

III. Empirical Tests for Limited Attention and Effort Allocation

In this section we present our empirical tests for limited attention and effort allocation in securities trading. To begin, we define the three attention measures used throughout our tests. We then present our primary tests based on pooled time-series and cross-sectional regressions. In Section IV, we provide additional analyses and robustness checks using both pooled regressions and firm-specific time-series regressions.

A. The Measurement of Specialist Attention

The effectiveness of our tests rests on our ability to measure how a specialist allocates attention across the stocks at his panel. To begin, we assert that the attention required for a given stock increases with the number of transactions and the absolute return during the period. For each stock, we define three estimates of required specialist attention. Our first measure is based on the number of transactions during a given trading period. Although this measure has the advantage of simplicity, it ignores the possibility that factors other than trade frequency may affect the required level of specialist attention.

To address this concern, we define a second measure based on the absolute return during the period and a third measure that incorporates both the trade frequency and absolute return during the period. One drawback of the third measure is that it requires an assumption about the relative importance of trades and absolute returns in determining specialist attention requirements. To minimize the inherent subjectivity in this measure, we standardize both trade frequency and absolute return by their respective standard deviations computed across all observations in the pooled data. By doing so, we implicitly assume that a period with trade frequency that is one standard deviation above zero requires the same

level of specialist attention as a period with absolute return that is one standard deviation above zero. For stock i and period t , our attention measures are defined formally as:

$$Attention_{1,i,t} = \frac{trdfreq_{i,t}}{\sigma_{trdfreq}}, \quad (1)$$

$$Attention_{2,i,t} = \frac{|bpret|_{i,t}}{\sigma_{|bpret|}} \quad (2)$$

$$Attention_{3,i,t} = Attention_{1,i,t} \times Attention_{2,i,t} \quad (3)$$

where $trdfreq_{i,t}$ is the number of trades for stock i during period t , $\sigma_{trdfreq}$ is the standard deviation of trade frequency across all stock-periods, $|bpret|_{i,t}$ is the absolute return in basis points for stock i during period t , and $\sigma_{|bpret|}$ is the standard deviation of $|bpret|$ across all stock-periods. A key feature of our attention measures is the assumption that a given trade frequency or absolute return requires the same level of attention regardless of the stock. For example, the standard deviation of trade frequency across all pooled observations is 59.6053. As a result, the value of $Attention_1$ for a period with 1,000 trades would be 16.78 (1000/59.6053) regardless of the stock involved.

To illustrate the characteristics of the attention measures, Panel A of Figure 2 plots the standardized values of trade frequency and absolute return for Exxon Mobil, where each data point represents one 30-minute interval during our sample period. The first measure, $Attention_1$, increases in trade frequency but ignores the substantial variation in absolute return. This measure is reflected in the vertical distance to each data point. The second measure, $Attention_2$, increases in absolute return but ignores variation in trade frequency. This is reflected in the horizontal distance to each data point. The third measure, $Attention_3$, incorporates both trade frequency and absolute return. This measure is reflected in the rectangle formed by $Attention_1$ and $Attention_2$ and allows for different degrees of required attention even for two stocks with the same level of trading activity or the same absolute return.¹³

[INSERT FIGURE 2 HERE]

As an additional illustration of the attention measures, Panel B of Figure 2 plots each stock's average standardized trade frequency relative to its average standardized absolute return. For example, ExxonMobil, Citigroup, and Home Depot have the highest average trade frequencies, but are not among the stocks with the highest average absolute return. Collins Aikman has the highest average absolute return, but has a relatively low average trade frequency. Finally, American Water Works and Gucci have the lowest average absolute returns in the sample and also have relatively low average trade frequencies. Even among the least active securities in the sample, there is significant variation in average absolute return. As a result, we expect the three attention measures to provide correlated but different information.

We report summary statistics for the attention measures in Table IV Panel A. The table reports the mean of each measure for each of the three trade activity subsamples, along with the p -value from a test of equality of means across the subsamples. For all three attention measures, means are significantly higher for the most active stocks than for the least active stocks, though the pattern is most evident for the measures that incorporate trade frequency. The mean value of $Attention_1$ ranges from 0.44 for inactive securities to 3.29 for active securities. Similarly, the mean value of $Attention_2$ ranges from 0.58 to 0.64 and the mean value of $Attention_3$ ranges from 0.31 to 2.23. This variation is consistent with our assumption that specialists tend to allocate more attention to actively traded securities.

[INSERT TABLE IV HERE]

The Limited Attention Hypothesis implies a negative relation between the provision of liquidity for a stock and the level of specialist attention devoted to other stocks at the same panel. Thus, the key variable of interest is 'panel attention.' For each stock and each period, we define $PanelAttention_1$ as the sum of $Attention_1$ across all *other* stocks at the panel, excluding the stock of interest. $PanelAttention_2$ and $PanelAttention_3$ are defined similarly based on $Attention_2$ and $Attention_3$. Panel B of Table IV reports summary statistics for these measures. The statistics indicate that smaller, less-active stocks have higher panel attention measures. This is consistent with less-active stocks being traded on larger panels. Conversely, the most active stocks have the lowest levels of panel attention, reflecting the tendency to place active securities on smaller panels.

To examine more directly whether the NYSE and specialist firms consider limited attention when assigning stocks to panels, we compare the cross-sectional distribution of panel attention using the actual NYSE stock assignments to the distribution that results from a random assignment of stocks to panels. We begin by assigning stocks randomly to panels while maintaining the actual distribution of panel sizes (as illustrated in Figure 1). Based on these stock assignments, we estimate panel attention measures for each panel each period and calculate the cross-sectional standard deviation of panel attention each period. We then calculate the average cross-sectional standard deviation across all time periods. We repeat this process 1,000 times. For the panel attention measures that incorporate trading activity ($Attention_1$ and $Attention_3$), the actual NYSE panel assignments result in a lower cross-sectional standard deviation than any of the 1,000 random allocations (a p -value of <0.001). This suggests that stocks are indeed assigned to panels in a manner that minimizes variation in attention across panels. For the attention measure based solely on returns ($Attention_2$), the p -value relative to the random allocations is 0.687. This result is not surprising given the difficulty in predicting returns.

To assess the differences in the three panel attention measures, we estimate their time-series correlation for each stock. The cross-sectional means of these correlations are reported in the last three rows of Panel B. Overall, the correlations are weakest between $Attention_1$ and $Attention_2$ and strongest between $Attention_2$ and $Attention_3$. The average correlation between $Attention_1$ and $Attention_2$ ranges from 0.32 for the most active stocks to 0.37 for the least active stocks. The average correlation between $Attention_1$ and $Attention_3$ ranges from 0.58 to 0.63 and the average correlation between $Attention_2$ and $Attention_3$ ranges from 0.80 to 0.83. In the regression analysis to follow, we provide results based on several combinations of these attention variables.

B. Pooled Time-Series and Cross-Sectional Regressions

To test the Limited Attention Hypothesis, we provide pooled time-series and cross-section regressions that take the following general form:

$$\begin{aligned}
Liquidity\ Measure_{it} = & \alpha + \sum_{p=2}^{13} \alpha_i \cdot HH_p + \beta_1 \cdot InvPrice_{it} + \beta_2 \cdot LogTrades_{it} + \beta_3 \cdot LogTradeSize_{it} \\
& + \beta_4 \cdot AbsReturn_{it} + \sum_{j=1}^J \gamma_j \cdot PanelAttention_{jit} + \varepsilon_{it},
\end{aligned} \tag{4}$$

where for each stock i , $AbsReturn_{it}$ is the absolute midpoint-to-midpoint return during period t , $InvPrice_{it}$ is the inverse of average trade price during period t , $LogTrades_{it}$ is the natural log of one plus the number of trades during period t , and $LogTradeSize_{it}$ is the natural log of one plus average trade size during period t . To control for intraday patterns in transaction costs we also include dummy variables (HH_p) to identify the 13 half-hour trading periods from 9:30 a.m. to 4:00 p.m.

We provide several specifications using both continuous and discrete measures of panel attention. As continuous measures, we include the natural log of one plus each panel attention measure. As discrete measures, we define dummy variables to identify periods of unusually high and low panel attention. Specifically, $BusyPanel_{it}$ ($SlowPanel_{it}$) is equal to one if both (i) $PanelAttention_{it}$ during period t is higher (lower) than the 75th (25th) percentile of observations for that panel, and (ii) $PanelAttention_{it}$ is higher (lower) than the 75th (25th) percentile of $PanelAttention_{it}$ across all stock-periods. The first characteristic identifies periods that are busy (slow) relative to the normal level of activity at that panel, while the second characteristic ensures a high (low) absolute level of activity relative to the rest of the trading floor.¹⁴

The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread.¹⁵ If the specialist decreases his participation in trading when other stocks at the panel require increasingly more attention, we expect the coefficients on $LogPanelAttention$ and $BusyPanel$ to be negative and the coefficient on $SlowPanel$ to be positive in the price improvement regressions. Since the probability of price improvement is increasing in with the width of the spread, we follow Petersen and Fialkowski (1994) by including the quoted spread as an additional explanatory variable in the price improvement regressions. This allows us to focus on variation in price improvement that is unrelated to variation in the quoted spread and the related placement of limit orders.

For the effective spread regressions, the expected signs on our key variables are the opposite. If transaction costs increase during periods of high panel attention, we expect the coefficients on *BusyPanel* and *LogPanelAttention* to be positive in the spread regressions. In addition, if the specialist is able to provide additional liquidity during periods when panel attention requirements are low, we expect the coefficient on *SlowPanel* to be negative in the spread regressions.

Given the pooled nature of the data, we expect the error terms in the model to include a security-specific component. To account for this, the model is estimated including one-way fixed effects. We assume that the error terms follow the structure $\varepsilon_{it} = v_i + u_{it}$, where v_i is a firm-specific fixed effect and u_{it} is the classical zero-mean error term.¹⁶

The regression results are provided in Table V. Models including the discrete measures of panel attention are described in Panel A. All control variables have the expected signs and the restrictions that firm fixed effects and time-of-day effects equal zero are easily rejected in all specifications. More importantly, both the *BusyPanel* and *SlowPanel* coefficients are significant and of the correct sign in the price improvement models, regardless of the measure of panel attention. The coefficients show that the rate and magnitude of price improvement decrease (increase) when the attention required by other stocks on the panel is unusually high (low). These results suggest that the specialist's ability to provide liquidity is negatively related to the attention requirements of other stocks at the panel, even after controlling for own-stock trading activity. In addition, the effects of panel attention are evident not only when attention requirements are unusually high, but also when attention requirements are unusually low.

[INSERT TABLE V HERE]

The results based on effective spreads, provide similar conclusions. The coefficient on *BusyPanel* is positive and significant for two of the three attention measures and the coefficient on *SlowPanel* is negative and significant for all three attention measures. These results suggest that transaction costs increase as the specialist allocates attention toward other securities at the same panel.

Panel B of Table V presents results based on continuous measures of panel attention. We provide three specifications for each dependent variable. The first specification includes just *PanelAttention*₁ and reflects only the trading activity at the panel. The second specification includes both *PanelAttention*₁ and *PanelAttention*₂. Finally, the third specification includes all three panel attention measures. Consistent with the results in Panel A, the findings suggest that price improvement decreases and transaction costs increase as the specialist allocates attention toward other securities at the panel. The coefficient on *PanelAttention*₁ is significantly negative in all price improvement regressions and significantly positive in the effective spread regressions. The coefficient on *PanelAttention*₂ is significant and of the correct sign when included with *PanelAttention*₁. However, this variable tends to decrease in significance when included with *PanelAttention*₃. This suggests that attention limits tend to be driven by the interaction of absolute return and trading activity, rather than just absolute return alone. The one exception is in the final effective spread regression, where both *PanelAttention*₁ and *PanelAttention*₂ are positive and significant, but *PanelAttention*₃ is negative and significant.

To examine the economic impact of limited attention, we estimate the predicted values of the price improvement rate and percentage effective spread based on the regression coefficients in Table V and the mean values of all explanatory variables. We also include the median firm fixed effect and the dummy variable for intraday period 6 (12:30-1:00). In the regressions based on *PanelAttention*₁, the coefficient on the *BusyPanel* dummy variable (Panel A) suggests that price improvement is approximately 2.40% lower and percentage effective spreads are approximately 1.75% higher during busy periods than during slow periods. Similarly, coefficients based on *PanelAttention*₃ suggest that price improvement is 3.03% lower and effective spreads are 1.54% higher during busy than during slow periods. The conclusions based on the continuous panel attention variables (Panel B) are similar. Here, the results suggest that price improvement decreases by 5.62% and percentage effective spreads increase by approximately 3.52% as *PanelAttention*₁ goes from the 10th to the 90th percentile.

To put these costs in perspective, it is useful to characterize total NYSE trading activity. The NYSE Fact Book reports that trading volume on the NYSE averaged approximately \$40 billion per day

during 2002. Based on $PanelAttention_1$, our data suggest that approximately 7.20 % of this volume, or \$2.88 billion, was executed during busy periods. Given the 19.49 basis point average effective spread during our sample period, a 3.0 % change would imply a floor-wide increase in trading costs of approximately \$168 thousand per day or \$42.1 million per year. While these cost estimates are only approximate, they suggest that the potential floor-wide benefits from reductions in capacity constraints (perhaps through the use of automatic execution systems) could be large.

C. Controls for Market-Wide Effects

The regressions reported above control for variation in own-stock characteristics that may affect price improvement and execution costs. However, the results may also reflect a correlation between individual security liquidity and market-wide effects. To control for this possibility, we extend the analysis to control for market-wide measures of liquidity and attention. Incorporating market liquidity provides a control for the commonality in liquidity documented by Chordia, Roll, and Subrahmanyam (2000). Incorporating market attention allows us to test whether panel attention effects are driven primarily by firm-specific or market-wide attention effects.

For each security and each intraday period, we define $MarketAttention_1$, $MarketAttention_2$, and $MarketAttention_3$ as the sum of $Attention_1$, $Attention_2$, and $Attention_3$, respectively, across all sample stocks that are not traded at the same panel as the security of interest. Similarly, for each liquidity variable, we define the corresponding market measure as the trade-weighted average of that variable across all sample stocks that are not traded at the same panel as the security of interest. To control for both market liquidity and market attention simultaneously, we employ a two-stage regression procedure. In the first stage, we remove systematic liquidity components using stock-specific time series OLS regressions, where the dependent variable is either a price improvement measure or the percentage effective spread and the explanatory variable is the corresponding market liquidity measure. The residuals from this regression reflect variation in stock liquidity that is unexplained by variation in market-wide liquidity. In the second stage, we use these residuals as the dependent variable in pooled regressions

similar to equation (4), where the corresponding market attention measures are added as explanatory variables. This two-stage procedure is used throughout Tables VI-VIII to control for market-wide liquidity and attention effects.¹⁷

The results from the second-stage regression are reported in Table VI Panel A.¹⁸ The results for both the rate and magnitude of price improvement provide strong evidence in support of the Limited Attention Hypothesis. The coefficient on *PanelAttention*₁ is negative and significant in every price improvement regression and the coefficient on *PanelAttention*₃ is negative and significant in all specifications where it is included. Again, the coefficient on *PanelAttention*₂ tends to be negative, but loses significance when included with *PanelAttention*₃. Overall, we conclude that both the magnitude and rate of price improvement are significantly affected by the attention requirements of the other stocks handled by the specialist, even after controlling for market-wide effects.

[INSERT TABLE VI HERE]

The results for effective spreads are mixed. The panel attention coefficients are insignificant in the first two specifications. In the third specification, the coefficient is positive and significant for *PanelAttention*₁ and *PanelAttention*₂, but negative and significant for *PanelAttention*₃. Thus, while panel attention requirements have strong effects on price improvement, the net effect on execution costs is difficult to determine. However, in subsequent analyses, the effective spread evidence supports the Limited Attention Hypothesis. We discuss these results in more detail below.

D. Expected vs. Unexpected Attention Requirements

The evidence in Table III suggests that panel assignments by NYSE specialist firms work to reduce the effects of limited attention. Specifically, stocks expected to require high levels of attention are assigned to small panels, while stocks with low expected attention requirements are assigned to larger panels. If total expected attention requirements differ across panels and the ability to handle extreme attention requirements is a skill that differs across specialists, we would also expect the most skilled specialists to be assigned to the busiest panels. These arguments suggest that it may be variation in unexpected rather than total attention requirements that drive differences in liquidity provision.

To test this hypothesis, we define the unexpected component of each panel attention measure. To begin, we calculate $Attention_1$, $Attention_2$, and $Attention_3$ for each stock-period during the three-month pre-sample period from May through June, 2002. These pre-sample attention measures are defined as in equations (1) through (3), where trade frequency and absolute return are standardized by their respective pre-sample standard deviations across all pooled observations. We then define expected attention for each stock as the median value of attention across all pre-sample periods. Next, for each stock during each 30-minute period from August through October 2002, we define the unexpected components of $Attention_1$, $Attention_2$, and $Attention_3$ by subtracting the expected attention estimate from the in-sample attention measures. Finally, for each stock-period, we define the unexpected component of each panel attention measure by summing the unexpected attention components across all panel stocks, excluding the stock of interest, and then demeaning the resulting variable to remove cross-stock differences in the level of unexpected panel attention.¹⁹ We also define the corresponding unexpected market attention measures using the same procedure and the set of all stocks not traded at the same panel as the stock of interest. Throughout the remaining analyses, we provide results for both total and unexpected panel attention. The conclusions are generally insensitive to the attention measure used.

Results from pooled regressions based on unexpected panel attention are provided in Table VI Panel B. Again, we control for market-wide effects using the two-stage regression procedure described in Section III.C. The results are generally similar to those in Panel A. Both the rate and magnitude of price improvement are significantly negatively related to unexpected panel attention based on $Attention_1$ and $Attention_3$. As in Panel A, unexpected $PanelAttention_2$ tends to lose significance when included with the combined return and trade frequency variable ($PanelAttention_3$). Together, the results in Table VI provide strong evidence that the attention requirements of the specialist have a significant effect on both the rate and magnitude of price improvement, even after controlling for market-wide effects. However, the results for effective spreads would seem to suggest that these price improvement effects may not translate into higher effective spreads. In additional tests to follow, we find that the negative relation between effective spreads and panel attention is driven primarily by the subsample of active securities and periods of high-

own trading activity. In fact, evidence from the individual security time-series regressions described in Section IV below provides strong support for a positive relation between effective spreads and panel attention, consistent with the Limited Attention Hypothesis.²⁰

IV. Additional Tests and Robustness Checks

In this section, we provide several additional tests to refine the analysis and test for robustness. First, we test whether the overall results are stronger in the subsample of inactive securities, where limited attention effects should be most pronounced. Second, we extend our pooled regressions to examine the relation between liquidity provision and panel attention when own-stock trading activity is within normal bounds. Finally, we provide an alternative test of the Limited Attention Hypothesis using stock-specific OLS time-series regressions.

A. Active vs. Inactive Securities

As discussed above, we expect the effects of limited attention to be most evident for the least active securities. To examine this hypothesis directly, we allow the coefficients on panel attention to differ across active and inactive stocks. For the purposes of this regression, we define *Active* stocks as the 500 most active stocks in our sample (the high- and mid-activity groups). The remaining stocks (the low-activity group) are defined as *Inactive*. To aid with interpretation, we include interactions for only one panel attention measure at a time. All regressions include the full set of control variables described in Section III.B., as well as the market liquidity and market attention variables described in Section III.C. To conserve space, the coefficients on these control variables are not reported.

We report the coefficients on panel attention variables for active and inactive securities in Table VII. For regressions based on total panel attention (panel A), the panel attention coefficient for inactive securities is of the correct sign and statistically significant in eight of the nine price improvement regressions and is significantly larger (in absolute terms) than for active securities in seven of the nine regressions. In the effective spread regressions, the coefficient on panel attention for inactive securities is positive and significant based on *Attention*₂ and *Attention*₃, but insignificant for *Attention*₁. Overall, these

results are consistent with the Limited Attention Hypothesis. In addition, the results for effective spreads suggest that the negative relation between panel attention and effective spreads reported in Table VI may reflect the inclusion of active securities.

[INSERT TABLE VII HERE]

The results are similar for regressions based on unexpected panel attention (panel B). In this case, the coefficient on panel attention for inactive securities is of the correct sign, statistically significant, and significantly larger (in absolute terms) than the coefficient for active securities in seven of the nine price improvement regressions. The relation between effective spreads and panel attention for inactive securities is positive and significant when based on $Attention_2$ and $Attention_3$ (as in Panel A), but negative and significant when based on $Attention_1$. Overall, the results in Table VII are consistent with our hypothesis that the effects of limited attention are most prominent for the least active NYSE stocks.

B. Controlling for Own-Stock Trading Activity

An important consideration in our tests is the potential correlation in order flow across stocks. For example, Hasbrouck and Seppi (2001) report strong positive co-variation in order flow across the 30 stocks in the Dow Jones Industrial Average. To isolate the effects of limited attention, we must be careful to control for the effects of own-stock trading activity. The interaction between own-stock trading activity and panel activity may also reveal something about the trading environment. For example, periods when own-stock activity is high but panel activity is low (or normal), may reflect significant firm-specific events. During these periods, spreads are likely to vary for reasons unrelated to limited attention effects.

Throughout the previous regressions, we control for own-stock trading activity by including own-stock trading characteristics as explanatory variables. In this section, we provide an additional test to control for own-stock trading. Specifically, we allow the effects of panel attention to differ across periods when own-stock trading is low, normal, or high. We expect periods of normal own-trading activity to provide the cleanest test of the Limited Attention Hypothesis.

To isolate periods of normal own-trading activity, we create three indicator variables that describe the level of each stock's trading activity in a given period relative to its own time-series mean and standard deviation. Specifically, we set *OwnHigh* (*OwnLow*) equal to one when a stock's trade frequency in a given period is more than one standard deviation above (below) its time-series mean. All other periods are defined as *Normal*. Using these indicator variables we modify our pooled regressions to allow the coefficient on panel attention to vary with own-stock trading activity. Again, to aid with interpretation, we include interactions for only one panel attention variable at a time.

The results, presented in Table VIII, provide strong evidence of a significant relation between price improvement and panel attention during periods of normal own-trading. The coefficients on both total panel attention (Panel A) and unexpected panel attention (Panel B) during normal own-trading periods are negative and significant in eight of the nine price improvement regressions. These findings confirm our general result that liquidity provision decreases with the level of attention allocated to other stocks at the same panel and suggest that our results are not driven by a correlation between stock and panel trading activity. The results for effective spreads are again mixed. However, the coefficients suggest that the negative relation between effective spreads and panel attention observed in Table VI may be due in part to high own-trading periods.

[INSERT TABLE VIII HERE]

C. Stock-Specific Time-Series Regressions

Although the pooled analysis should minimize the potential endogeneity bias associated with NYSE stock allocation decisions, these effects may not be eliminated. As an additional check, we provide a robustness test of the Limited Attention Hypothesis using stock-specific time-series regressions. These OLS regressions eliminate cross-security effects and focus solely on the time-series relation between panel attention and liquidity provision.

To test the Limited Attention Hypothesis in this setting, we examine the cross-sectional distribution of the time series regression coefficients. This is similar to the methodology used by Chordia

et al. (2000). The results are reported in Table IX. For each specification, we report the median panel attention coefficient across all individual stock regressions along with the p -value from a sign test of whether the cross-sectional median is significantly different from zero. We also report the percentage of coefficients that are of the correct sign. Results for the control variables are generally consistent with those from the pooled analysis and are not reported.

[INSERT TABLE IX HERE]

Panels A and B provide results from OLS regressions replicating the busy/slow dummy variable analysis and the total panel attention analysis in Panels A and B of Table V, respectively. Panels C and D provide results from OLS regressions replicating the total and unexpected attention analysis in Panels A and B of Table VI. In all cases, the results provide strong evidence in support of the limited attention hypothesis. Both the rate and magnitude of price improvement are significantly negatively related to panel attention, whether measured using busy period dummy variables or continuous measures of panel attention. In addition, the results provide evidence of a significant positive relation between effective spreads and panel attention, even after controlling for market-wide variation in liquidity and attention.

Overall, the results in Table IX provide strong evidence that both the magnitude and rate of price improvement decrease and execution costs increase as the attention required by other stocks at the same panel increases. These results also suggest that our pooled evidence is robust to potential endogeneity concerns and to alternative estimation methods. Together with the results from Tables V through VIII, these findings indicate that the specialist's ability to provide liquidity is significantly affected by limited attention and the allocation of effort across securities.

V. Summary and Conclusions

It is well known that human beings are limited in their ability to process information and to perform multiple tasks simultaneously (see Kahneman (1973) and Pashler (1998) for reviews). Despite the documented importance of limited attention in other settings, its impact on financial markets has only recently attracted attention. Recent research provides evidence that, when faced with complicated

information, investors resort to simplified decision rules such as categorization. Theoretical studies also suggest that limited attention on the part of investors may have significant effects on asset price behavior and financial reporting decisions by firms. To date, however, empirical studies have been limited by the absence of direct measures of attention and its allocation across securities.

This study provides the first direct evidence that limited attention influences the provision of liquidity in financial markets. Since individual NYSE specialists are assigned a well-defined set of securities, this setting provides an ideal framework for analyzing the allocation of limited attention across securities. We show that the specialist's ability to provide liquidity for a particular stock is significantly affected by the attention requirements of other securities traded at the same location. Consistent with the Limited Attention Hypothesis, our evidence indicates that market makers face attention limits and they allocate their effort across securities during periods when attention constraints are binding. In the process, their ability to act as an important source of liquidity is reduced for at least a subset of the securities in their market making portfolio. Therefore, while the design of the NYSE may yield diversification and/or subsidization benefits by allowing specialists to handle a portfolio of stocks, our paper identifies potential costs associated with this organizational arrangement.

It is important to note that we do not argue that specialists actively impair liquidity during periods when panel attention requirements are high. Instead, it is likely that the specialist is unable to act as an additional source of liquidity during these periods, leaving spreads to be determined primarily by the actions of other traders. During normal conditions, the specialist steps in to facilitate trade and act as an important source of liquidity. During busy periods, however, the specialist's ability to provide this service is limited.

This research has important implications for future theoretical work considering the influence of limited attention on trading. While prior studies suggest that limited attention may affect the demand for securities, we show that attention limits may also influence prices through the supply of liquidity. Our paper also has implications for the allocation of stocks on the trading floor and contributes to the ongoing debate over the merits of floor-based versus electronic trading. In particular, increased automation, such

as that currently being implemented on the NYSE, may relieve specialist capacity constraints and reduce the necessity to allocate effort across stocks. While our tests are based on NYSE data our findings may be applicable to any market where dealer effort is allocated across multiple securities.

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Figure 1. Distribution of panel size. The figure illustrates the distribution of panel size on the New York Stock Exchange as of August 1, 2002. Panel A reflects panel size based on the full sample of 3,599 securities in the August 1st NYSE Specialist Directory. Panel B reflects panel size after restricting the sample to only common stocks and ADRs as identified in CRSP (N=1,920).

Figure 2. Comparison of specialist attention estimates. The figure illustrates three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. Panel A plots time series observations of standardized trade frequency and standardized absolute return for Exxon Mobil (XOM) and illustrates the three attention variables used in the analysis. $Attention_1$ is the standardized trade frequency and is reflected in the vertical distance to each data point. $Attention_2$ is the standardized absolute return and is reflected in the horizontal distance to each data point. $Attention_3$ is an interaction defined as product of $Attention_1$ and $Attention_2$ and is reflected in the area of the rectangle formed by $Attention_1$ and $Attention_2$. Panel B plots mean values of standardized trade frequency and standardized absolute return for each sample security.

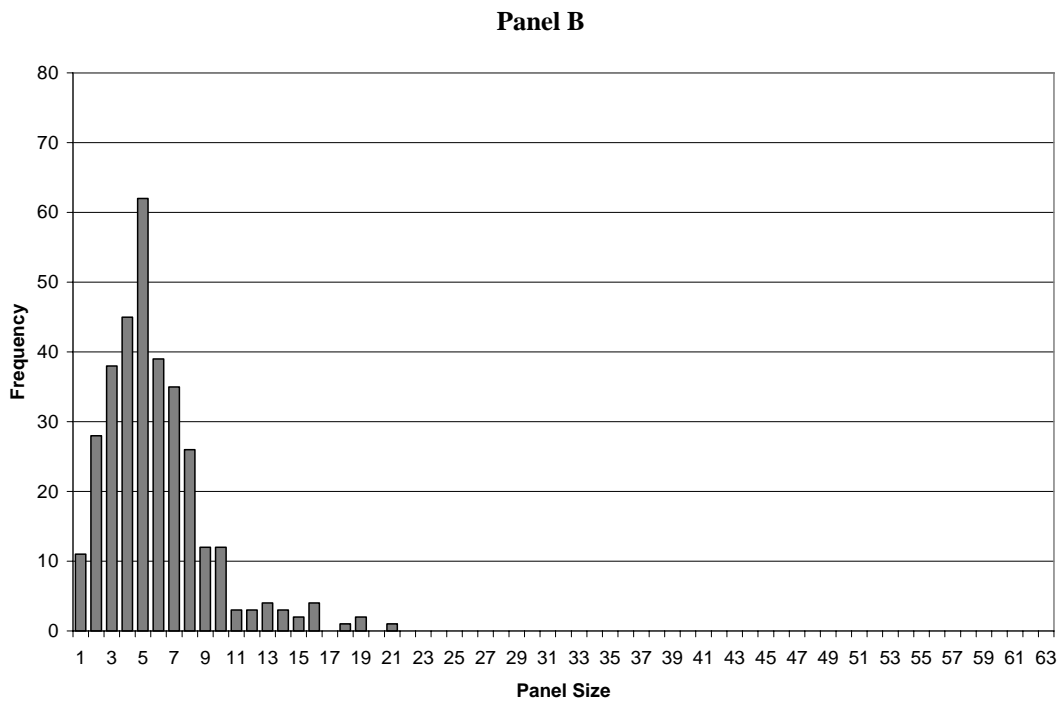
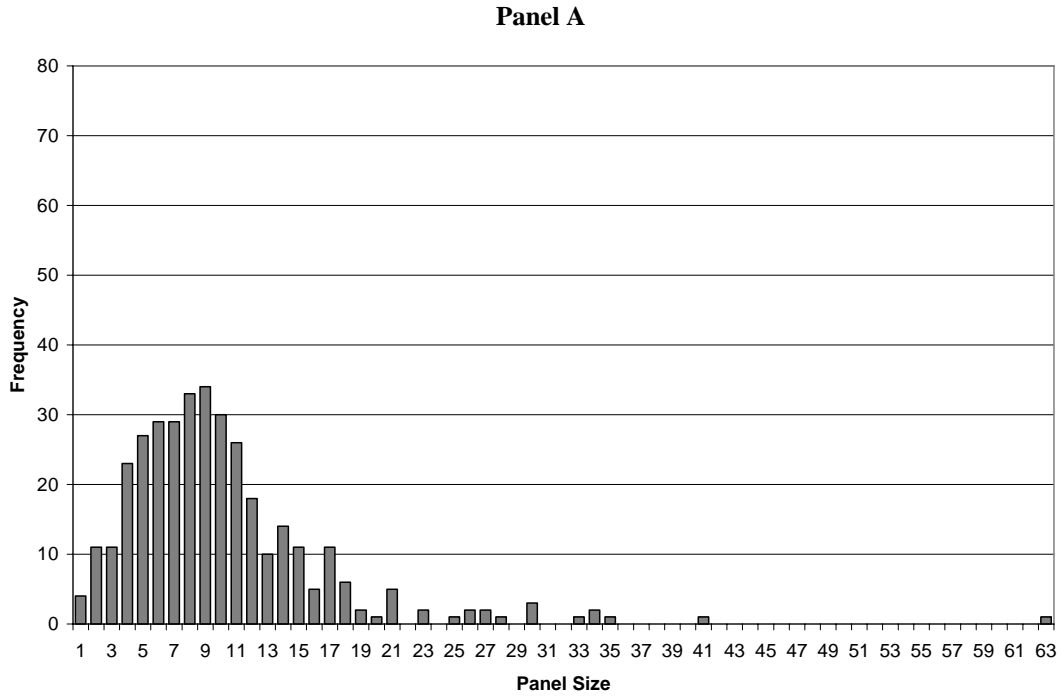
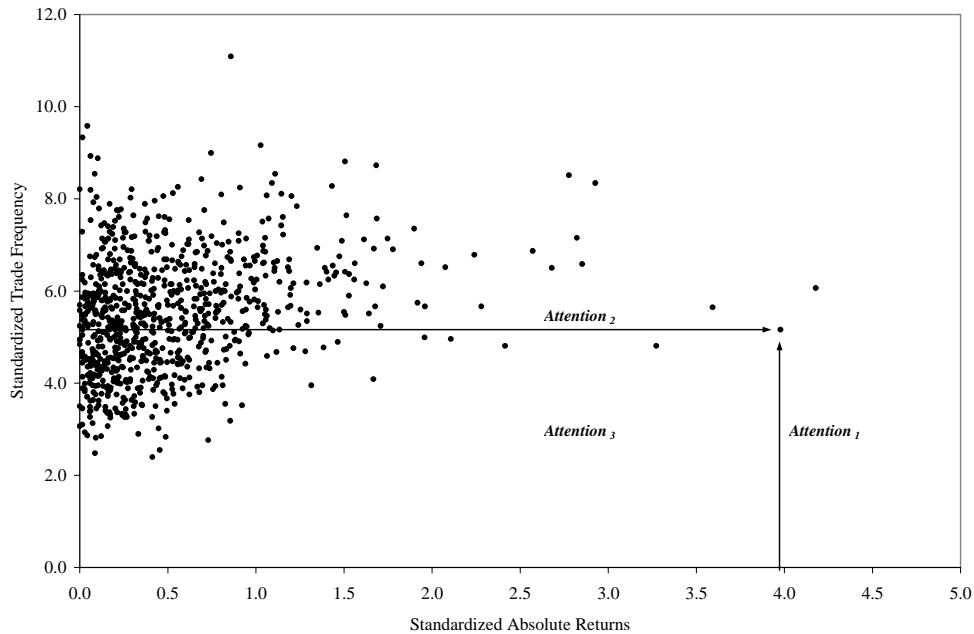


Figure 1. Distribution of panel size. The figure illustrates the distribution of panel size on the New York Stock Exchange as of August 1, 2002. Panel A reflects panel size based on the full sample of 3,599 securities in the August 1st NYSE Specialist Directory. Panel B reflects panel size after restricting the sample to only common stocks and ADRs as identified in CRSP (N=1,920).

Panel A – Standardized measures of trade frequency and absolute return for Exxon Mobil



Panel B – Individual stock averages of standardized trade frequency and standardized absolute return

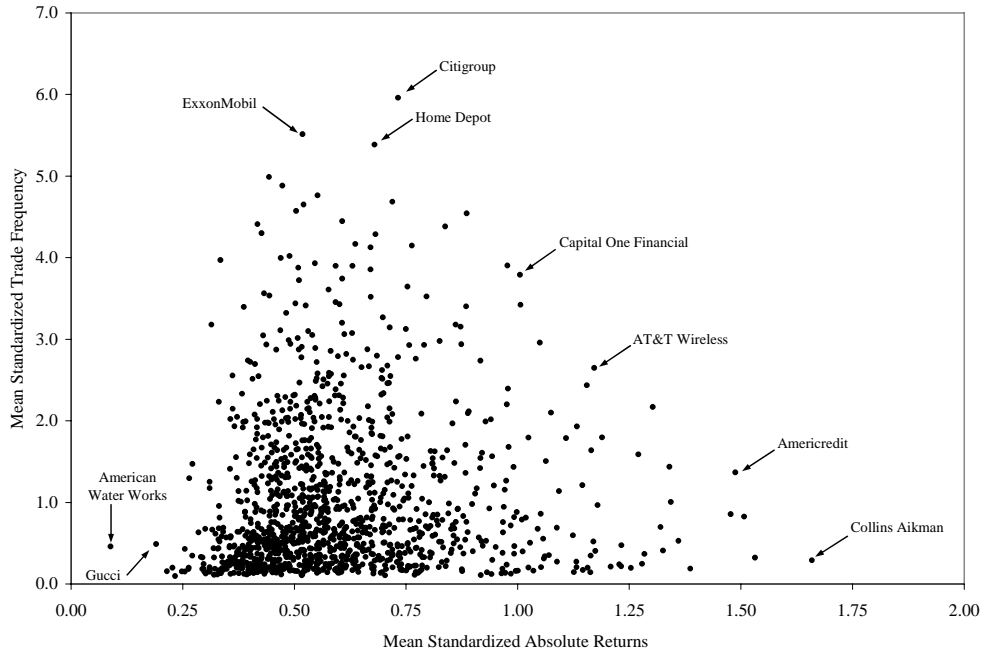


Figure 2. Comparison of specialist attention estimates. The figure illustrates three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. Panel A plots time series observations of standardized trade frequency and standardized absolute return for Exxon Mobil (XOM) and illustrates the three attention variables used in the analysis. *Attention₁* is the standardized trade frequency and is reflected in the vertical distance to each data point. *Attention₂* is the standardized absolute return and is reflected in the horizontal distance to each data point. *Attention₃* is an interaction defined as the product of *Attention₁* and *Attention₂* and is reflected in the area of the rectangle formed by *Attention₁* and *Attention₂*. Panel B plots mean values of standardized trade frequency and standardized absolute return for each sample security.

Table I
Summary Statistics

The table reports summary statistics for the sample of 1,252 common stocks and ADRs listed on the NYSE from August 1 through October 31, 2002. All securities meet the following restrictions: (1) included in both CRSP and the NYSE Specialist Directory for the entire sample period, (2) no stock splits during the sample period, (3) an average transaction price greater than \$3 and less than \$200, (4) a minimum transaction price greater than \$2, and (5) at least one trade in 800 of the 840 available 30-minute trading periods. Quoted spreads, effective spreads, and the magnitude of price improvement are defined as trade-weighted averages during each 30-minute period. The rate of price improvement is defined as the proportion of all trades that occur at prices inside the bid-ask quotes. For each security, variables are averaged across all intraday trading periods and we report the cross-sectional average of these individual stock means. Panel B reports cross-sectional means by trade activity category, where stocks are divided into three categories based on the average daily number of trades during the pre-sample period from May through July, 2002: the 100 most-active stocks, the next 400 most-active stocks, and the least active 752 stocks. The *p*-value in panel B is from a test of the restriction that means are equal across trade activity categories, based on analysis of variance.

Panel A – Full Sample				
	Mean	Median	Min	Max
Half-hours traded	837.32	840.00	800.00	840.00
Price (\$)	26.50	23.39	3.15	121.73
Dollar volume per half-hour (\$millions)	1.93	0.54	0.02	42.01
Share volume per half-hour (thousands)	66.74	25.57	1.69	1332.34
Trades per half-hour	60.40	40.09	5.77	355.81
Trade size	788.28	605.84	196.55	6208.99
Absolute 30-min midpoint return (bps)	56.79	52.53	8.43	158.23
Rate of price improvement (% of trades)	36.26	36.22	15.22	54.84
Magnitude of price improvement (¢)	1.44	1.34	0.41	5.57
Magnitude of price improvement (bps)	7.36	5.71	1.59	47.63
Quoted spread (¢)	5.21	4.84	1.83	22.93
% Quoted spread (bps)	26.85	20.70	6.52	159.23
Effective spread (¢)	3.77	3.49	1.26	19.81
% Effective spread (bps)	19.49	14.90	4.38	114.41
Panel B – Trade Activity Subsamples				
	High Activity (N=100)	Mid Activity (N=400)	Low Activity (N=752)	<i>p</i> -value
Half-hours traded	839.88	839.93	835.60	0.000
Price (\$)	38.69	31.44	22.25	0.000
Dollar volume per half-hour (\$millions)	11.46	2.51	0.35	0.000
Share volume per half-hour (thousands)	347.43	89.49	17.31	0.000
Trades per half-hour	198.65	90.29	26.11	0.000
Trade size	1704.81	940.73	585.31	0.000
Absolute 30-min midpoint return (bps)	61.78	58.54	55.20	0.000
Rate of price improvement (% of trades)	39.12	36.28	35.88	0.000
Magnitude of price improvement (¢)	1.35	1.28	1.52	0.000
Magnitude of price improvement (bps)	4.43	5.16	8.92	0.000
Quoted spread (¢)	4.47	4.48	5.69	0.000
% Quoted spread (bps)	14.21	17.82	33.34	0.000
Effective spread (¢)	3.12	3.20	4.17	0.000
% Effective spread (bps)	9.77	12.65	24.41	0.000

Table II
Panel Characteristics

The table provides specialist panel characteristics from the NYSE trading floor as of August 1, 2002. In the first row, panel size is defined based on the full set of 3,599 securities listed in the NYSE Specialist Directory. In row two, panel size is defined based on the set of 1,920 common stocks and ADRs with available CRSP data. In row three, panel size is defined based on the final restricted sample of 1,252 stocks. All securities in the final sample meet the following restrictions: (1) included in both CRSP and the NYSE Specialist Directory for the entire sample period, (2) no stock splits during the sample period, (3) an average transaction price greater than \$3 and less than \$200, (4) a minimum transaction price greater than \$2, and (5) at least one trade in 800 of the 840 available 30-minute trading periods. % Post Change and % Panel Change are the proportions of securities in each sample that change post or panel locations, respectively, during the sample period.

Sample	Panels	Panel Size				Securities	% Post Changes	% Panel Changes
		Mean	Min	Median	Max			
Full Specialist Directory	357	10.1	1.0	9.0	63.0	3,599	15.0	27.8
Common Stocks	331	5.8	1.0	5.0	21.0	1,920	17.6	31.5
Final Restricted Sample	312	4.0	1.0	4.0	12.0	1,252	17.3	32.4

Table III
Panel Size and Trading Characteristics by Trade Activity Category

The table provides average panel size and trading characteristics for the restricted sample of 1,252 common stocks and ADRs listed on the NYSE from August 1 through October 31, 2002. All securities meet the following restrictions: (1) included in both CRSP and the NYSE Specialist Directory for the entire sample period, (2) no stock splits during the sample period, (3) an average transaction price greater than \$3 and less than \$200, (4) a minimum transaction price greater than \$2, and (5) at least one trade in 800 of the 840 available 30-minute trading periods. For each security, panel and trading characteristics are averaged across all intraday trading periods and we report the cross-sectional average of these individual stock means. Sample stocks are divided into three categories based on the average daily number of trades during the pre-sample period from May through July, 2002: the 100 most-active stocks, the next 400 most-active stocks, and the least active 752 stocks. Means are reported separately for each category. In the first row, panel size is defined based on the full set of 3,599 securities listed in the August 1st NYSE Specialist Directory. In rows two through five, panel size, panel rank, and market share are defined based on the sample of 1,920 common stocks and ADRs with available CRSP data. The *p*-value is from a test of the restriction that means are equal across trade activity categories, based on analysis of variance.

	Trade Activity Category:			<i>p</i> -value
	High Activity (N=100)	Mid Activity (N=400)	Low Activity (N=752)	
All Securities at Panel	7.90	9.48	12.96	0.000
All Common Stocks at Panel	4.48	5.88	8.01	0.000
Rank among Common Stocks at Panel	1.20	1.86	3.84	0.000
Share of Dollar Volume at Panel (%)	68.01	36.40	11.18	0.000
Share of Trades at Panel (%)	58.07	33.78	13.22	0.000

Table IV
Measures of Attention Required by a Specialist

The table provides summary statistics for three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. $Attention_1$ is equal to the standardized trade frequency. $Attention_2$ is equal to the standardized absolute return. $Attention_3$ is an interaction defined as $Attention_1 * Attention_2$. Panel A reports the cross-sectional mean of each individual stock attention measure. Panel B reports the cross-sectional mean of each panel attention measure, where $PanelAttention_1$ is defined for each stock as the sum of $Attention_1$ across all other stocks at the same specialist panel, excluding the stock of interest. $PanelAttention_2$ and $PanelAttention_3$ are defined similarly, based on $Attention_2$ and $Attention_3$, respectively. Panel B also reports the cross-sectional mean of the time-series correlations between the various panel attention measures. Results are provided separately for the 100 most active stocks, the next 400 most active stocks, and the 752 least active stocks, based on trade frequency during the pre-sample period from May through July, 2002. The p -values are from a test of the restriction that means are equal across trade activity categories, based on analysis of variance.

Panel A –Individual Stock Attention Measures				
	Trade Activity Category:			p -value
	High Activity (N=100)	Mid Activity (N=400)	Low Activity (N=752)	
$Attention_1$	3.33	1.51	0.44	0.000
$Attention_2$	0.64	0.61	0.58	0.001
$Attention_3$	2.23	1.01	0.31	0.000
Panel B –Panel Attention Measures				
$PanelAttention_1$	2.69	3.34	3.51	0.000
$PanelAttention_2$	1.92	2.86	3.94	0.000
$PanelAttention_3$	1.88	2.41	2.48	0.000
correlation ($PanelAttention_1, PanelAttention_2$)	0.317	0.345	0.374	0.000
correlation ($PanelAttention_1, PanelAttention_3$)	0.579	0.586	0.627	0.000
correlation ($PanelAttention_2, PanelAttention_3$)	0.827	0.808	0.796	0.000

Table V
Pooled Regressions of Liquidity on Panel Attention

The table reports coefficient estimates from pooled time-series and cross-section regressions of price improvement and transaction costs on measures of panel attention. The model includes 1,252 firms and 840 30-minute trading periods from August 1 through October 31, 2002. The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread. The rate of price improvement is defined as the percentage of trades during the 30-minute interval that are executed inside the bid-ask quotes. The magnitude of price improvement is defined as the difference between the trade price and the relevant quote, stated either as a dollar amount or a percentage of the quote midpoint. Both effective spreads and the magnitude of price improvement are defined as a trade-weighted average within each 30-minute interval. The independent variables include the inverse of the average trade price (*InvPrice*), the natural log of the average number of trades (*LogTrades*), the natural log of the average trade size (*LogTradeSize*), and the absolute return of midpoint-to-midpoint returns (*AbsReturn*) during the period. We define three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. *Attention₁* is equal to the standardized trade frequency. *Attention₂* is equal to the standardized absolute return. *Attention₃* is an interaction defined as *Attention₁***Attention₂*. *PanelAttention₁* is then defined for each stock period as the sum of *Attention₁* across all other stocks at the same specialist panel, excluding the stock of interest. *PanelAttention₂* and *PanelAttention₃* are defined similarly, based on *Attention₂* and *Attention₃*, respectively. In Panel A, the model is estimated using dummy variables to identify *Busy* and *Slow* periods at a given panel. The dummy variables are defined separately based on *PanelAttention₁*, *PanelAttention₂*, and *PanelAttention₃*, where *Busy (Slow)* periods are defined as periods for which the panel attention measure is (i) in the top (bottom) 25% of observations for that panel, and (ii) in the top (bottom) 25% of all pooled panel attention observations. In Panel B, the model is estimated including the log of panel attention measures. All models also include firm fixed effects and time-of-day effects. *p*-values are reported in parentheses below the coefficients.

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	1	2	3	1	2	3	1	2	3	1	2	3
Panel A – Dummy Variables for Busy and Slow Panels												
Attention Measure:	1	2	3	1	2	3	1	2	3	1	2	3
Intercept	25.374 (0.000)	25.540 (0.000)	25.558 (0.000)	-0.048 (0.137)	-0.045 (0.157)	-0.042 (0.191)	-3.976 (0.000)	-3.948 (0.000)	-3.909 (0.000)	15.048 (0.000)	14.986 (0.000)	15.090 (0.000)
<i>InvPrice</i>	1.629 (0.180)	1.411 (0.245)	1.882 (0.121)	0.259 (0.000)	0.246 (0.000)	0.264 (0.000)	89.800 (0.000)	89.721 (0.000)	89.887 (0.000)	201.549 (0.000)	201.564 (0.000)	201.526 (0.000)
<i>LogTrades</i>	1.275 (0.000)	1.262 (0.000)	1.271 (0.000)	0.048 (0.000)	0.047 (0.000)	0.047 (0.000)	0.084 (0.000)	0.080 (0.000)	0.083 (0.000)	-1.706 (0.000)	-1.703 (0.000)	-1.707 (0.000)
<i>LogTradeSize</i>	-1.090 (0.000)	-1.080 (0.000)	-1.082 (0.000)	-0.023 (0.000)	-0.023 (0.000)	-0.023 (0.000)	-0.252 (0.000)	-0.249 (0.000)	-0.249 (0.000)	0.565 (0.000)	0.561 (0.000)	0.563 (0.000)
<i>AbsReturn</i>	-0.692 (0.000)	-0.680 (0.000)	-0.671 (0.000)	-0.003 (0.020)	-0.003 (0.034)	-0.002 (0.077)	0.616 (0.000)	0.619 (0.000)	0.623 (0.000)	3.667 (0.000)	3.661 (0.000)	3.666 (0.000)
<i>Quoted Spread</i>	2.540 (0.000)	2.540 (0.000)	2.540 (0.000)	0.302 (0.000)	0.302 (0.000)	0.302 (0.000)	1.455 (0.000)	1.455 (0.000)	1.456 (0.000)	-	-	-
<i>BusyPanel</i>	-0.509 (0.000)	-0.492 (0.000)	-0.722 (0.000)	-0.022 (0.000)	-0.009 (0.007)	-0.024 (0.000)	-0.151 (0.000)	-0.102 (0.000)	-0.247 (0.000)	0.179 (0.000)	0.204 (0.000)	-0.020 (0.664)
<i>SlowPanel</i>	0.373 (0.000)	0.315 (0.000)	0.389 (0.000)	0.013 (0.000)	0.010 (0.001)	0.013 (0.000)	0.120 (0.000)	0.121 (0.000)	0.112 (0.000)	-0.113 (0.000)	-0.189 (0.000)	-0.278 (0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.270	0.270	0.270	0.562	0.562	0.563	0.484	0.484	0.484	0.602	0.602	0.602

Table V - continued

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	Panel B – Continuous Measures of Panel Attention											
<i>Intercept</i>	27.701 (0.000)	27.912 (0.000)	27.558 (0.000)	0.052 (0.110)	0.057 (0.081)	0.419 (0.204)	-3.370 (0.000)	-3.283 (0.000)	-3.455 (0.000)	14.053 (0.000)	13.951 (0.000)	13.813 (0.000)
<i>InvPrice</i>	2.815 (0.020)	3.182 (0.009)	3.324 (0.006)	0.313 (0.000)	0.319 (0.000)	0.324 (0.000)	90.079 (0.000)	90.198 (0.000)	90.257 (0.000)	200.989 (0.000)	200.856 (0.000)	200.903 (0.000)
<i>LogTrades</i>	1.305 (0.000)	1.310 (0.000)	1.309 (0.000)	0.049 (0.000)	0.049 (0.000)	0.049 (0.000)	0.091 (0.000)	0.092 (0.000)	0.092 (0.000)	-1.720 (0.000)	-1.722 (0.000)	-1.722 (0.000)
<i>LogTradeSize</i>	-1.100 (0.000)	-1.089 (0.000)	-1.087 (0.000)	-0.023 (0.000)	-0.023 (0.000)	-0.023 (0.000)	-0.254 (0.000)	-0.251 (0.000)	-0.250 (0.000)	0.569 (0.000)	0.565 (0.000)	0.566 (0.000)
<i>AbsReturn</i>	0.690 (0.000)	-0.670 (0.000)	-0.663 (0.000)	-0.003 (0.024)	-0.002 (0.051)	-0.002 (0.082)	0.616 (0.000)	0.623 (0.000)	0.626 (0.000)	3.666 (0.000)	3.658 (0.000)	3.660 (0.000)
<i>Quoted Spread</i>	2.540 (0.000)	2.541 (0.000)	2.541 (0.000)	0.302 (0.000)	0.302 (0.000)	0.302 (0.000)	1.456 (0.000)	1.456 (0.000)	1.456 (0.000)	-	-	-
<i>LogPanelAttention₁</i>	-1.230 (0.000)	-1.005 (0.000)	-0.668 (0.000)	-0.053 (0.000)	-0.049 (0.000)	-0.036 (0.000)	-0.320 (0.000)	-0.247 (0.000)	-0.107 (0.005)	0.525 (0.000)	0.441 (0.000)	0.554 (0.000)
<i>LogPanelAttention₂</i>	-	-0.426 (0.000)	-0.120 (0.024)	-	-0.008 (0.000)	0.004 (0.230)	-	-0.138 (0.000)	-0.010 (0.687)	-	0.158 (0.000)	0.261 (0.000)
<i>LogPanelAttention₃</i>	-	-	-0.429 (0.000)	-	-	-0.016 (0.000)	-	-	-0.178 (0.000)	-	-	-0.143 (0.001)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R^2	0.270	0.270	0.270	0.563	0.563	0.563	0.484	0.484	0.484	0.602	0.602	0.602

Table VI
Pooled Regressions of Liquidity on Total and Unexpected Panel Attention Controlling for Market-Wide Effects

The table reports coefficient estimates from pooled time-series and cross-section regressions of price improvement and transaction costs on measures of unexpected panel attention. The model includes 1,252 firms and 840 30-minute trading periods from August 1 through October 31, 2002. The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread. The rate of price improvement is defined as the percentage of trades during the 30-minute interval that are executed inside the bid-ask quotes. The magnitude of price improvement is defined as the difference between the trade price and the relevant quote, stated either as a dollar amount or a percentage of the quote midpoint. Both effective spreads and the magnitude of price improvement are defined as a trade-weighted average within each 30-minute interval. The independent variables include the inverse of the average trade price (*InvPrice*), the natural log of the average number of trades (*LogTrades*), the natural log of the average trade size (*LogTradeSize*), and the absolute return of midpoint-to-midpoint returns (*AbsReturn*) during the period. For brevity, we do not report the coefficients on the control variables, as they do not change substantially from those reported on Table V. We define three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. *Attention₁* is equal to the standardized trade frequency. *Attention₂* is equal to the standardized absolute return. *Attention₃* is an interaction defined as *Attention₁***Attention₂*. *PanelAttention₁* is then defined for each stock period as the sum of *Attention₁* across all other stocks at the same specialist panel, excluding the stock of interest. *PanelAttention₂* and *PanelAttention₃* are defined similarly, based on *Attention₂* and *Attention₃*, respectively. Panel attention is further separated into expected and unexpected components, where expected attention is defined for each stock as the time-series median of attention for that stock during the pre-sample period from May through June, 2002, and expected panel attention is the sum of expected attention across all stocks at the panel, excluding the stock of interest. We control for both market-wide liquidity and market-wide attention effects using a two-stage regression procedure. In the first stage, we remove systematic liquidity effects by regressing each dependent variable on a corresponding market measure, defined as the equally-weighted average of the variable across all stocks that are not traded at the same panel. The residuals from the first stage are then used as the dependent variable in a second-stage pooled regression which follows the specification from Table V and also controls for market attention, defined as the sum of individual stock attention across all stocks not traded at the same panel. All models include firm fixed effects and time-of-day effects. *p*-values are reported in parentheses below the coefficients. Results for total panel attention are provided in Panel A and results for unexpected panel attention are provided in Panel B.

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	Panel A – Total Panel Attention											
<i>LogPanelAttention₁</i>	-1.014 (0.000)	-0.852 (0.000)	-0.588 (0.000)	-0.057 (0.000)	-0.044 (0.000)	-0.040 (0.000)	-0.296 (0.000)	-0.214 (0.000)	-0.141 (0.000)	-0.028 (0.642)	0.031 (0.616)	0.208 (0.003)
<i>LogPanelAttention₂</i>	-	-0.276 (0.000)	-0.033 (0.535)	-	-0.007 (0.002)	-0.002 (0.630)	-	-0.052 (0.004)	0.009 (0.732)	-	0.030 (0.359)	0.173 (0.000)
<i>LogPanelAttention₃</i>	-	-	-0.356 (0.000)	-	-	-0.008 (0.018)	-	-	-0.092 (0.000)	-	-	-0.217 (0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.413	0.413	0.235	0.237	0.237	0.059	0.060	0.060

Table VI - continued

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	Panel B – Unexpected Panel Attention											
<i>UnexpectedPanelAttention₁</i>	-0.151 (0.000)	-0.131 (0.000)	-0.073 (0.000)	-0.008 (0.000)	-0.007 (0.000)	-0.005 (0.000)	-0.052 (0.000)	-0.047 (0.000)	-0.035 (0.000)	-0.060 (0.000)	-0.054 (0.000)	-0.054 (0.002)
<i>UnexpectedPanelAttention₂</i>	-	-0.045 (0.000)	-0.019 (0.008)	-	-0.001 (0.000)	-0.000 (0.522)	-	-0.001 (0.808)	0.005 (0.153)	-	0.002 (0.665)	0.002 (0.736)
<i>UnexpectedPanelAttention₃</i>	-	-	-0.056 (0.000)	-	-	-0.002 (0.000)	-	-	-0.012 (0.001)	-	-	0.000 (0.961)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.412	0.412	0.235	0.237	0.237	0.059	0.060	0.060

Table VII
Pooled Regressions of Liquidity on Panel Attention by Trade Activity Category

The table reports coefficient estimates from pooled time-series and cross-section regressions of price improvement and transaction costs on measures of panel attention. In these regressions, we allow the slope on panel attention to differ across active and inactive stocks, where active stocks include the top 500 stocks ranked by median trading activity during the pre-sample period and inactive stocks include the remaining 752 sample stocks. The model includes 1,252 firms and 840 30-minute trading periods from August 1 through October 31, 2002. The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread. The rate of price improvement is defined as the percentage of trades during the 30-minute interval that are executed inside the bid-ask quotes. The magnitude of price improvement is defined as the difference between the trade price and the relevant quote, stated either as a dollar amount or a percentage of the quote midpoint. Both effective spreads and the magnitude of price improvement are defined as a trade-weighted average within each 30-minute interval. The independent variables include the inverse of the average trade price (*InvPrice*), the natural log of the average number of trades (*LogTrades*), the natural log of the average trade size (*LogTradeSize*), and the absolute return of midpoint-to-midpoint returns (*AbsReturn*) during the period. For brevity, we do not report the coefficients on the control variables, as they do not change substantially from those reported on Table V. We define three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. *Attention*₁ is equal to the standardized trade frequency. *Attention*₂ is equal to the standardized absolute return. *Attention*₃ is an interaction defined as *Attention*₁**Attention*₂. *PanelAttention*₁ is then defined for each stock period as the sum of *Attention*₁ across all other stocks at the same specialist panel, excluding the stock of interest. *PanelAttention*₂ and *PanelAttention*₃ are defined similarly, based on *Attention*₂ and *Attention*₃, respectively. Panel attention is further separated into expected and unexpected components, where expected attention is defined for each stock as the time-series median of attention for that stock during the pre-sample period from May through June, 2002, and expected panel attention is the sum of expected attention across all stocks at the panel, excluding the stock of interest. We control for both market-wide liquidity and market-wide attention effects using a two-stage regression procedure. In the first stage, we remove systematic liquidity effects by regressing each dependent variable on a corresponding market measure, defined as the equally-weighted average of the variable across all stocks that are not traded at the same panel. The residuals from the first stage are then used as the dependent variable in a second-stage pooled regression which follows the specification from Table V and also controls for market attention, defined as the sum of individual stock attention across all stocks not traded at the same panel. All models also include firm fixed effects and time-of-day effects. *p*-values are reported in parentheses below the coefficients. In addition, we report an *F*-test of the restriction that the coefficient on panel attention is equal across trade activity categories. Results for total panel attention are provided in Panel A and results for unexpected panel attention are provided in Panel B.

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	1	2	3	1	2	3	1	2	3	1	2	3
Panel A – Total Panel Attention												
<i>Inactive*</i>	-1.474	-0.677	-0.819	-0.080	-0.026	-0.035	-0.402	-0.001	-0.103	-0.004	0.394	0.179
<i>LogPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.956)	(0.000)	(0.957)	(0.000)	(0.000)
<i>Active*</i>	-0.340	0.102	-0.116	-0.024	0.007	-0.001	-0.142	-0.187	-0.196	-0.064	-0.500	-0.463
<i>LogPanelAttention</i>	(0.000)	(0.061)	(0.013)	(0.000)	(0.025)	(0.813)	(0.002)	(0.000)	(0.000)	(0.448)	(0.000)	(0.000)
F-statistic	92.02	152.94	164.70	62.58	81.01	111.36	21.97	39.81	13.39	0.37	288.86	196.96
(<i>p</i> -value)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.540)	(0.000)	(0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.411	0.412	0.235	0.237	0.236	0.059	0.059	0.059

Table VII - continued

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	1	2	3	1	2	3	1	2	3	1	2	3
Panel B – Unexpected Panel Attention												
<i>Inactive*</i>	-0.212	-0.078	-0.115	-0.011	-0.003	-0.005	-0.070	0.006	-0.003	-0.052	0.039	0.042
<i>UnexpectedPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.066)	(0.406)	(0.005)	(0.000)	(0.000)
<i>Active*</i>	-0.046	0.038	-0.012	-0.002	0.003	0.000	-0.021	-0.031	-0.034	-0.074	-0.126	-0.086
<i>UnexpectedPanelAttention</i>	(0.090)	(0.000)	(0.191)	(0.206)	(0.000)	(0.627)	(0.091)	(0.000)	(0.000)	(0.001)	(0.000)	(0.000)
F-statistic	31.82	110.31	94.59	28.57	75.22	57.40	12.29	49.59	38.11	0.82	322.49	208.24
(p-value)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.366)	(0.000)	(0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.412	0.412	0.235	0.236	0.236	0.059	0.060	0.060

Table VIII
Pooled Regressions of Liquidity on Panel Attention by Own-Stock Trading Activity

The table reports coefficient estimates from pooled time-series and cross-section regressions of price improvement and transaction costs on measures of panel attention. In these regressions, we allow both the intercept and the slope on panel attention to differ based on the level of own-stock trading activity. To classify own-stock trading activity, we estimate the time-series mean and standard deviation of the number of trades for each stock. Periods of *Low (High)* own trading are then defined as periods where trading activity is more than one standard deviation below (above) the stock-specific mean. All other periods are defined as *Normal*. The model includes 1,252 firms and 840 30-minute trading periods from August 1 through October 31, 2002. The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread. The rate of price improvement is defined as the percentage of trades during the 30-minute interval that are executed inside the bid-ask quotes. The magnitude of price improvement is defined as the difference between the trade price and the relevant quote, stated either as a dollar amount or a percentage of the quote midpoint. Both effective spreads and the magnitude of price improvement are defined as a trade-weighted average within each 30-minute interval. The independent variables include the inverse of the average trade price (*InvPrice*), the natural log of the average number of trades (*LogTrades*), the natural log of the average trade size (*LogTradeSize*), and the absolute return of midpoint-to-midpoint returns (*AbsReturn*) during the period. For brevity, we do not report the coefficients on the control variables, as they do not change substantially from those reported on Table V. We define three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. *Attention₁* is equal to the standardized trade frequency. *Attention₂* is equal to the standardized absolute return. *Attention₃* is an interaction defined as *Attention₁*Attention₂*. *PanelAttention₁* is then defined for each stock period as the sum of *Attention₁* across all other stocks at the same specialist panel, excluding the stock of interest. *PanelAttention₂* and *PanelAttention₃* are defined similarly, based on *Attention₂* and *Attention₃*, respectively. Panel attention is further separated into expected and unexpected components, where expected attention is defined for each stock as the time-series median of attention for that stock during the pre-sample period from May through June, 2002, and expected panel attention is the sum of expected attention across all stocks at the panel, excluding the stock of interest. We control for both market-wide liquidity and market-wide attention effects using a two-stage regression procedure. In the first stage, we remove systematic liquidity effects by regressing each dependent variable on a corresponding market measure, defined as the equally-weighted average of the variable across all stocks that are not traded at the same panel. The residuals from the first stage are then used as the dependent variable in a second-stage pooled regression which follows the specification from Table V and also controls for market attention, defined as the sum of individual stock attention across all stocks not traded at the same panel. All models also include firm fixed effects and time-of-day effects. *p*-values are reported in parentheses below the coefficients. Results for total panel attention are provided in Panel A and results for unexpected panel attention are provided in Panel B.

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	1	2	3	1	2	3	1	2	3	1	2	3
Panel A – Total Panel Attention												
<i>OwnLow*</i>	-0.953	-0.379	-0.442	-0.003	0.015	0.002	-0.014	0.065	-0.007	-0.027	0.249	0.107
<i>LogPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.320)	(0.000)	(0.327)	(0.497)	(0.000)	(0.717)	(0.694)	(0.000)	(0.027)
<i>OwnNormal*</i>	-1.007	-0.370	-0.518	-0.013	-0.006	-0.008	-0.069	-0.012	-0.037	-0.038	0.042	-0.096
<i>LogPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.161)	(0.000)	(0.530)	(0.199)	(0.001)
<i>OwnHigh*</i>	-1.109	-0.395	-0.604	-0.013	-0.003	-0.006	-0.068	-0.031	-0.052	0.025	-0.080	-0.203
<i>LogPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.242)	(0.005)	(0.003)	(0.063)	(0.002)	(0.705)	(0.049)	(0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.409	0.409	0.234	0.239	0.237	0.059	0.059	0.059

Table VIII - continued

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
	1	2	3	1	2	3	1	2	3	1	2	3
Panel A – Total Panel Attention												
<i>OwnLow*</i>	0.081	-0.019	-0.032	0.006	0.005	0.004	-0.005	0.011	-0.001	0.082	0.053	0.013
<i>UnexpectedPanelAttention</i>	(0.080)	(0.212)	(0.055)	(0.040)	(0.000)	(0.000)	(0.833)	(0.126)	(0.858)	(0.035)	(0.000)	(0.366)
<i>OwnNormal*</i>	-0.175	-0.055	-0.081	-0.010	-0.003	-0.004	-0.062	-0.003	-0.016	-0.067	0.018	0.007
<i>UnexpectedPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.404)	(0.000)	(0.000)	(0.001)	(0.223)
<i>OwnHigh*</i>	-0.192	-0.047	-0.078	-0.008	-0.001	-0.002	-0.041	-0.015	-0.019	-0.116	-0.132	-0.081
<i>UnexpectedPanelAttention</i>	(0.000)	(0.000)	(0.000)	(0.000)	(0.359)	(0.001)	(0.014)	(0.012)	(0.002)	(0.000)	(0.000)	(0.000)
<i>Firm Fixed Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
<i>Time-of-Day Effects</i>	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
R ²	0.152	0.152	0.152	0.411	0.412	0.412	0.235	0.236	0.236	0.059	0.060	0.060

Table IX
Individual Stock OLS Regressions of Liquidity on Panel Attention

The table summarizes coefficient estimates from individual-stock ordinary least squares regressions of price improvement and transaction costs on measures of panel attention. For each security, the model includes 840 30-minute trading periods from August 1 through October 31, 2002. The dependent variables include the rate of price improvement, the dollar and percentage magnitude of price improvement, and the percentage effective spread. The rate of price improvement is defined as the percentage of trades during the 30-minute interval that are executed inside the bid-ask quotes. The magnitude of price improvement is defined as the difference between the trade price and the relevant quote, stated either as a dollar amount or a percentage of the quote midpoint. Both effective spreads and the magnitude of price improvement are defined as a trade-weighted average within each 30-minute interval. All models include the following independent variables: the inverse of the average trade price (*InvPrice*), the natural log of the average number of trades (*LogTrades*), the natural log of the average trade size (*LogTradeSize*), and the absolute return of midpoint-to-midpoint returns (*AbsReturn*) during the period. We define three alternative measures of specialist attention based on standardized trade frequency and standardized absolute return. For each stock and each 30-minute period, trade frequency is defined as the number of trades and absolute return is defined as the absolute value of the midpoint-to-midpoint return during the period. Both variables are then standardized by their respective standard deviation calculated across all pooled time-series and cross-sectional observations. *Attention₁* is equal to the standardized trade frequency. *Attention₂* is equal to the standardized absolute return. *Attention₃* is an interaction defined as *Attention₁***Attention₂*. *PanelAttention₁* is then defined for each stock period as the sum of *Attention₁* across all other stocks at the same specialist panel, excluding the stock of interest. *PanelAttention₂* and *PanelAttention₃* are defined similarly, based on *Attention₂* and *Attention₃*, respectively. Panel attention is further separated into expected and unexpected components, where expected attention is defined for each stock as the time-series median of attention for that stock during the pre-sample period from May through June, 2002, and expected panel attention is the sum of expected attention across all stocks at the panel, excluding the stock of interest. The models also control for both market-wide liquidity and market-wide attention effects, where market liquidity is defined as the equally-weighted average of the dependent variable across all stocks that are not traded at the same panel and market attention is defined as the sum of individual stock attention across all stocks not traded at the same panel. The table reports the median coefficient across the 1,252 sample stocks, as well as a *p*-value from the sign test of the hypothesis that the cross-section median is zero (in parentheses) and the percentage of coefficients that have the correct sign (in brackets). Panels A and B replicate the pooled regressions in Table V Panels A and B, respectively, and do not include controls for market-wide effects. Panels C and D replicate the pooled regressions in Table VI Panels A and B, respectively, and control for both market-wide liquidity and market-wide attention effects.

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (¢)			Magnitude of Price Improvement (%)			Effective Spread (%)		
Panel A – Coefficient Summary for Busy and Slow Panel Dummy Variables (Replication of Table V Panel A)												
Attention Measure:	1	2	3	1	2	3	1	2	3	1	2	3
<i>BusyPanel</i>	-0.513 (0.000) [59.84]	-0.494 (0.000) [60.75]	-0.591 (0.000) [62.64]	-0.021 (0.000) [60.11]	-0.012 (0.000) [55.30]	-0.017 (0.000) [58.16]	-0.094 (0.000) [60.29]	-0.041 (0.006) [53.21]	-0.056 (0.000) [57.68]	0.082 (0.000) [58.66]	0.091 (0.000) [58.90]	0.077 (0.000) [58.11]
<i>SlowPanel</i>	0.315 (0.000) [55.39]	0.373 (0.000) [58.81]	0.432 (0.000) [59.98]	0.011 (0.001) [54.55]	0.010 (0.000) [55.50]	0.010 (0.000) [57.11]	0.052 (0.000) [55.67]	0.045 (0.000) [56.91]	0.049 (0.000) [58.55]	-0.018 (0.258) [51.58]	-0.005 (0.168) [50.72]	-0.012 (0.177) [52.69]
Median R ²	0.257	0.256	0.257	0.577	0.577	0.577	0.580	0.581	0.581	0.877	0.877	0.877

Table IX - continued

Dependent Variable:	Rate of Price Improvement			Magnitude of Price Improvement (€)			Magnitude of Price Improvement (%)			Effective Spread (%)		
Panel B – Coefficient Summary for Total Panel Attention (Replication of Table V Panel B)												
<i>LogPanelAttention₁</i>	-1.405 (0.000) [62.46]	-1.124 (0.000) [59.50]	-0.841 (0.000) [57.03]	-0.044 (0.000) [62.70]	-0.038 (0.000) [59.90]	-0.034 (0.000) [57.43]	-0.204 (0.000) [63.74]	-0.174 (0.000) [60.22]	-0.152 (0.000) [58.07]	0.157 (0.000) [61.18]	0.134 (0.000) [59.03]	0.122 (0.000) [56.15]
<i>LogPanelAttention₂</i>	-	-0.508 (0.000) [64.62]	-0.351 (0.000) [56.95]	-	-0.015 (0.000) [59.90]	-0.006 (0.075) [52.40]	-	-0.056 (0.000) [60.62]	-0.027 (0.020) [52.88]	-	0.046 (0.000) [58.55]	0.016 (0.499) [51.76]
<i>LogPanelAttention₃</i>	-	-	-0.250 (0.000) [54.55]	-	-	-0.003 (0.007) [51.84]	-	-	-0.018 (0.074) [51.52]	-	-	0.036 (0.001) [53.35]
Median R ²	0.260	0.261	0.261	0.578	0.579	0.579	0.582	0.582	0.582	0.877	0.877	0.877
Panel C – Coefficient Summary for Total Panel Attention after Controlling for Market Wide Effects (Replication of Table VI Panel A)												
<i>LogPanelAttention₁</i>	-0.921 (0.000) [59.03]	-0.709 (0.000) [56.39]	-0.467 (0.001) [53.83]	-0.031 (0.000) [58.31]	-0.031 (0.000) [57.19]	-0.024 (0.000) [55.11]	-0.116 (0.000) [56.95]	-0.089 (0.000) [55.59]	-0.090 (0.000) [54.79]	0.139 (0.000) [57.91]	0.124 (0.000) [56.95]	0.118 (0.000) [55.35]
<i>LogPanelAttention₂</i>	-	-0.334 (0.000) [59.19]	-0.180 (0.016) [53.43]	-	-0.006 (0.000) [54.95]	0.000 (0.639) [49.84]	-	-0.019 (0.001) [54.23]	-0.001 (0.883) [50.16]	-	0.033 (0.000) [54.95]	-0.006 (0.300) [49.36]
<i>LogPanelAttention₃</i>	-	-	-0.221 (0.000) [54.55]	-	-	-0.005 (0.007) [52.16]	-	-	-0.014 (0.086) [51.36]	-	-	0.032 (0.001) [53.67]
Median R ²	0.264	0.265	0.265	0.579	0.580	0.580	0.583	0.583	0.583	0.877	0.878	0.878
Panel D – Coefficient Summary for Unexpected Panel Attention after Controlling for Market-Wide Effects (Replication of Table VI Panel B)												
<i>UnexpectedPanelAttention₁</i>	-0.187 (0.000) [58.39]	-0.163 (0.000) [56.63]	-0.114 (0.000) [54.79]	-0.007 (0.000) [57.67]	-0.007 (0.000) [57.03]	-0.005 (0.000) [54.39]	-0.026 (0.000) [57.43]	-0.024 (0.000) [56.95]	-0.016 (0.001) [54.23]	0.028 (0.000) [57.67]	0.022 (0.000) [57.11]	0.018 (0.001) [54.23]
<i>UnexpectedPanelAttention₂</i>	-	-0.071 (0.000) [60.14]	-0.050 (0.000) [56.07]	-	-0.001 (0.000) [54.63]	-0.001 (0.290) [52.24]	-	-0.005 (0.000) [54.71]	-0.004 (0.109) [52.88]	-	0.005 (0.002) [54.55]	0.005 (0.753) [52.24]
<i>UnexpectedPanelAttention₃</i>	-	-	-0.025 (0.008) [52.96]	-	-	-0.001 (0.033) [52.00]	-	-	-0.005 (0.062) [52.88]	-	-	0.005 (0.023) [52.56]
Median R ²	0.262	0.263	0.264	0.579	0.581	0.581	0.582	0.584	0.584	0.877	0.877	0.878

¹ See Kahneman (1973) and Pashler (1998) for detailed discussions of attention limits and attention allocation. Limited attention is also related to the concept of ‘bounded rationality,’ which has been applied extensively to other economic questions. For a general discussion of bounded rationality, see Simon (1955, 1979) and Sargent (1993). See Gifford (2005) for a discussion of limited attention as a bound on rationality.

² In related work, Arbel and Strebel (1982) and Arbel, Carvell, and Strebel (1983) argue that investors will demand higher expected returns for holding “neglected” or “generic” stocks. Similarly, Klein and Bawa (1977) and Barry and Brown (1984, 1986) develop models in which the quality of available information differs across securities.

³ In a different setting, Hirshleifer and Teoh (2003) and Hirshleifer, Lim, and Teoh (2004) show that firms may alter their financial reporting decisions in settings where investors are subject to limited attention. Limited attention has also been applied in models of behavior within organizations. A common framework in these models is that of a manager who must allocate limited effort across multiple projects (e.g., Radner and Rothschild (1975) and Gifford (2005)).

⁴ Gabaix and Laibson (2005) and Gabaix, Laibson, Moloche, and Weinberg (2006) develop a general cost-benefit model of endogenous attention allocation and provide experimental evidence in support of this directed cognition effect. See Peng (2005) for an application to financial markets.

⁵ We note that individual specialists share market-making risks and rewards by forming specialist firms. Prior research finds that liquidity provision differs across specialist firms (see Cao, Choe, and Hatheway (1997) and Corwin (1999)). Additionally, Coughenour and Deli (2002) and Coughenour and Saad (2004) find that transaction cost differences and covariation in transaction costs can be partially explained by specialist firm characteristics. Although firm-level effects may exist, we focus on whether individual specialists allocate attention across their set of assigned stocks.

⁶ Schwartz (1993) notes that 11 stocks were reallocated across specialist firms due to poor performance following October 1987. Stocks are also reassigned following specialist firm mergers. Corwin (2004) describes specialist mergers and associated stock assignments from 1992 through 1998. Hatch and Johnson (2002) analyze the impact of specialist mergers on market quality.

⁷ Models of inventory costs include Stoll (1978), Ho and Stoll (1981), and O’Hara and Oldfield (1986)). Models of adverse selection costs include Copeland and Galai (1983), Glosten and Milgrom (1985), and Easley and O’Hara

(1987)). Prior research also suggests that the NYSE specialist can play a unique role in managing adverse selection risks by averaging profits across time or across trades (Glosten (1989) and Leach and Madhavan (1993)) and by forming relationships with floor traders (Benveniste, Marcus, and Wilhelm (1992)). Empirical studies of NYSE specialist behavior generally support both inventory and adverse selection effects. See, for example, Hasbrouck and Sofianos (1993), Madhavan and Smidt (1993), Madhavan and Sofianos (1998), and Kavajecz (1999).

⁸ To the extent that limited attention effects are most pronounced for the least active securities, these restrictions should bias our tests against the Limited Attention Hypothesis. As a robustness test, we repeated the pooled regression analysis including the 1,461 securities that trade in at least 630 (75%) of the intraday periods. As expected, the 219 added securities are very inactive and their transaction cost estimates are relatively noisy. For example, these stocks average only five trades per half-hour period and have an average of 548 (of 840) periods with fewer than five trades. In general, however, the conclusions are unchanged if this less-restrictive sample is used.

⁹ We apply several standard filters to the trade and quote data. To calculate attention measures, we utilize only NYSE trades that occur during regular trading hours, have a positive price and quantity traded, have normal condition codes, and have trade correction codes less than 2. To calculate liquidity measures, we exclude trades for which the associated quotes have bid or offer depth that is non-positive, a bid-ask spread that exceeds \$5, a bid or ask that differs by more than 25% from the preceding quote, or a bid or ask with mode other than 1, 2, 6, 10, or 12. We also exclude the first trade each day, trades with condition codes denoting delayed execution, trades for which the effective spread exceeds \$5, and trades for which the price differs by more than 25% from the preceding price.

¹⁰ We determine trade direction based on the Lee and Ready (1991) algorithm with one modification. As suggested by Bessembinder (2003), trades are compared to contemporaneous quotes rather than to quotes outstanding five seconds prior to the trade. Using recent data, Bessembinder suggests that comparing trades to contemporaneous quotes is optimal when determining trade direction and price improvement. To the extent that this algorithm results in trade classification errors, these errors should be evident both inside and outside the quotes. As a robustness check, we reestimated the rate of price improvement results using net price improvement, defined as the proportion of trades inside the quotes minus the proportion of trades outside the quotes. The conclusions based on this alternative measure are similar. On average, 0.9% of trades take place at prices less than the bid or greater than the ask.

¹¹ Because trade activity categories are defined based on the pre-sample period, stocks included in the high (low) trade activity category may not be the most (least) active stocks during the sample period. In a prior version of the paper, we defined trade activity categories based on in-sample trading. Our conclusions are not sensitive to the categorization method.

¹² Both Nortel Networks and CIT Group trade at larger panels for most of the sample period. As of October 31, 2002, only three ETFs (SPY, QQQ, and DIA) and one common stock (OM Group) traded alone at a panel. OM Group was moved to a single-stock panel on the last day of the sample period. None of these securities are included in the subsequent regression analysis.

¹³ $Attention_3$ will be highest when *both* trade frequency and absolute return are high. In previous versions of the paper, we used an alternative attention measure defined as $\sqrt{\text{standardized trade freq}^2 + \text{standardized absolute return}^2}$. Unlike the current $Attention_3$, this alternative attention measure could be high if *either* trade frequency or absolute return is high. The conclusions are similar if this alternative measure is used. The results are also similar if we define $Attention_3$ as the square root of (standardized trade frequency \times standardized absolute return).

¹⁴ We include the latter restriction because, due to the nature of the stocks at the panel, some panels may always be active or inactive relative to other panels on the NYSE trading floor. Results are qualitatively similar if we define busy and slow periods using only (i). Based on the combined restrictions, 6.65% (6.04%) of total stock-period observations are classified as busy (slow) based on $PanelAttention_1$ and 8.64% (8.01%) of observations are classified as busy (slow) based on $PanelAttention_2$.

¹⁵ We report evidence throughout the paper based on the percentage effective spread. We also performed tests based on the dollar quoted spread, the percentage quoted spread, and the dollar effective spread. Conclusions based on these alternative measures are similar.

¹⁶ For completeness, we also estimated the models using random effects (not reported). A Hausman test easily rejects the random effects specification for all models.

¹⁷ This two-stage procedure has three advantages over a single pooled regression. First, it is conservative in that all systematic liquidity components are removed before analyzing panel attention effects. Second, it reduces multicollinearity issues associated with including both market-wide liquidity and market-wide attention in the same regression. Third, it avoids the problem of including an explanatory variable in the pooled regression that is a cross-

sectional average of the dependent variable. Nevertheless, the conclusions are unchanged if we instead estimate a pooled regression that simultaneously includes both the market liquidity and market attention variables.

¹⁸ Throughout the remaining analyses, the coefficients on the control variables are similar to those in Table V. To conserve space, these coefficients are not reported.

¹⁹ Demeaning panel attention removes cross-stock differences in the level of panel attention, allowing us to focus on time series effects. The conclusions are generally similar if we do not demean panel attention. Unlike total panel attention, unexpected panel attention can be either positive or negative. As a result, we do not use a log specification for unexpected panel attention. To remove the effects of extreme outliers, we winsorize unexpected attention at the 0.1 and 99.9 percentiles. The conclusions are generally unchanged if we winsorize at alternative levels.

²⁰ Our panel attention measures are, by definition, highly correlated with market activity. To address this issue, we repeated the analysis using a market spread estimate that is not constructed from our dependent or independent variables. Specifically, we use the trade-weighted average spread on the SPDR (S&P500) exchange traded fund. These regressions provide support for the Limited Attention Hypothesis.