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journal homepage: www.elsevier.com/locate/jfecLimited disclosure and hidden orders in asset markets[☆]Cyril Monnet^{a,b,*}, Erwan Quintin^c^a Department of Economics, University of Bern, Shanzheckstrasse 1, 3001 Bern, Switzerland^b Studienzentrum Gerzensee, Dorfstr. 2, CH-3115 Gerzensee, Switzerland^c Real Estate and Urban Land Economics, Wisconsin Business School, 5257 Grainger Hall, 975 University Avenue, Madison, WI 53706, USA

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ABSTRACT

Opacity assumes at least two prominent forms in asset markets. Dark exchanges and over-the-counter markets enable expert investors to hide their orders while originators carefully control the disclosure of fundamental information about the assets they source. We describe a simple model in which both forms of opacity – hidden orders and limited disclosure – complement one another. Costly investor expertise gives originators incentives to deliver assets of good quality. Keeping expert orders hidden generates the rents investors need to justify investing in expertise in the first place. Limiting disclosure mitigates the resulting adverse selection issues. Originators prefer to restrict the information they can convey to experts because it encourages the participation of non experts. This optimal organization of asset markets can be decentralized using standard financial arrangements.

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1. Introduction

Some financial markets are highly opaque. Trading venues including dark exchanges and most over-the-counter (OTC) markets enable institutional investors to keep the details of their orders hidden from other investors at origination, a form of pre-trade opacity emphasized by Bolton, Santos, and Scheinkman (2016). In addition and as discussed, for instance, by Pagano and Volpin (2012) in the context of asset-backed securitization, originators and underwriting intermediaries often withhold fundamental information from all investors, whether institutional or retail.

In this paper, we make the case that the coexistence of hidden orders and limited disclosure is essential as long

as expertise is necessary in financial markets. The idea is simple. Expertise is costly for investors to acquire, but it is necessary to give originators incentives to deliver quality assets. Transparent venues would allow non experts to free ride on the investment of experts. The ability to hide orders allows experts to recoup their cost.¹ But non expert investors could then have cold feet, as they legitimately fear that experts will exploit their ignorance, thus limiting the amount of liquidity at origination. Originators, or a financial intermediary representing them, can encourage the participation of non experts by curtailing the flow of fundamental information to level the playing field between investors.

In our model, risk-neutral agents (originators) generate productive assets at a cost. Assets are of heterogeneous quality drawn from a known distribution. Investors are endowed with funds that they can either store safely or

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¹ This aspect of our model is closely related to Grossman and Stiglitz (1980). They argue that, when it is costly for investors to become informed, markets cannot be informationally efficient because otherwise returns to information acquisition would be zero.

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invest in the risky assets originators create. Investors can choose to become expert at a cost, which means that they can understand the fundamental asset information originators convey to them. When originator effort is unobservable, the presence of expert investors rewards originators for producing quality assets.

In such a context, limiting the disclosure of fundamental information to all investors can be strictly welfare-enhancing. Intuitively, non expert investors are reluctant to participate in asset markets because originators with good projects prefer to deal with experts who can recognize the quality of their projects. Hiding fundamental information levels the playing field between investors hence encourages the participation of non experts.

Implementing the optimal informational arrangement via regulations would be difficult on practical and legal grounds. But, we show that contracts that are standard in financial markets can implement the desired information design. Originators can sell their project forward before asset quality is revealed, can hire an underwriter and design their compensation so that they will opt for the optimal disclosure policy, or can enter into a blank-check underwriting arrangement with investors.

The set of results we develop in this paper builds on a large literature devoted to the optimal level of information in asset markets. Ever since the seminal work of Hirshleifer (1971) it is well understood that in second best environments the optimal level of disclosure is typically not full. This idea has been revived in recent work by Dang, Gorton, Holmstrom, and Ordonez (2013), Andolfatto, Berentsen, and Waller (2014), Monnet and Quintin (2013), Fishman and Hagerty (2003), and Pagano and Volpin (2012), among many others.

Both Dang, Gorton, Holmstrom, and Ordonez (2013) and Monnet and Quintin (2013) argue that limited disclosure preserves the liquidity of risky investments. Dang, Gorton, Holmstrom, and Ordonez (2013) implement the optimal disclosure level by delegating investments to an intermediary they interpret as a bank. Monnet and Quintin (2013) focus on the impact of information releases on secondary market liquidity.

By focusing on adverse selection issues this paper is more closely related to Pagano and Volpin (2012). They show that, in a world with differently sophisticated investors, partial disclosure can serve to mitigate the winner's curse that arises when less knowledgeable investors must bid for assets alongside expert investors with a superior ability to interpret fundamental information.² The same idea is at the core of this paper but our goal is to fully characterize the optimal disclosure design in primary markets with differently skilled investors. Whereas Pagano and Volpin (2012) study the information-control problem from the point of view of a given issuer, discussing the social role of opacity as we do requires a model in which the

volume of origination is fully endogenous.³ Among other key insights, such a model reveals that primary asset markets should optimally feature a juxtaposition of trading platforms with different ratio of expert to non expert investors and different levels of disclosure.

Bolton, Santos, and Scheinkman (2016) also study the social value of costly information acquisition in a model with experts and Boeotian investors. They interpret expert-only exchanges as OTC markets and use their framework to ask whether suboptimal investments in expertise should be expected in asset markets. Just like in our model, absent moral hazard the presence of experts leads to cream skimming and inefficient origination levels. But, introducing moral hazard creates a socially useful role for costly information acquisition. These commonalities notwithstanding, our focus and main message are different from theirs. Their main point is that opacity in asset markets generally leads to excessive expert rents and suboptimal origination volumes. We are arguing essentially the contrary; opacity, carefully designed, can mitigate the negative welfare impact caused by adverse selection issues in markets in which experts play an essential role. Expert-only exchanges play a similar role in our model as in theirs. They enable experts to hide their orders hence to generate rents. We argue that the resulting adverse selection issues should be mitigated by optimally controlling the disclosure of fundamental asset information to all investors. Rents always adjust in our model to exactly offset expertise acquisition cost and opacity, optimally designed, serves to make aggregate rents as small a fraction of origination volumes as possible in decentralized markets.⁴

Kurlat (2015) describes a model in which informed and non-informed agents coexist and, like us, describes the trading arrangements that should emerge given this juxtaposition. His focus, however, is on trading and rationing protocols, while we require that markets clear in a model in which agents take other agents' willingness to pay for assets as given. We focus on the transparency characteristics of the trading venues that emerge in the resulting market environment with a fully endogenous fraction of experts and non experts.

³ Pagano and Volpin (2012) also discuss the socially optimal level of disclosure but one issuer at a time and from a completely different point of view. They study the trade-off between liquidity in primary markets and liquidity in secondary markets in a version of their model where sophisticated investors can invest in information acquisition after the primary trading stage is complete. They show that lack of transparency in primary markets can exacerbate adverse selection issues in secondary markets. If those secondary liquidity issues are associated with a greater risk of dead weight losses caused, e.g., by fire sales, issuers do not select the socially optimal level of transparency. We focus on the amount of primary disclosure that leads to the socially optimal level of productive origination.

⁴ The other primary objective of Bolton, Santos, and Scheinkman (2016) is to propose a mechanism that could explain why expert rents in finance keep increasing even as the number of experts is rising because this corresponds to their reading of the evidence presented in Philippon and Reshef (2012). While this is not our primary concern, our model makes the same prediction when expertise acquisition costs are heterogeneous across investors, without altering any of our other results. See, in particular, footnote 11. Other papers that focus on expertise rents in the financial industry include Philippon (2008) and Biais, Rochet, and Woolley (2010).

² The idea that optimal disclosure is not full when some buyers cannot process fundamental information is also in Fishman and Hagerty (2003). They take the size of the market and the fraction of sophisticated buyers as exogenous, whereas we ask whether limiting disclosure can help support additional, welfare-enhancing origination.

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