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# Corporate governance and stock liquidity dimensions: Panel evidence from pure order-driven Australian market



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## ABSTRACT

Our newly constructed index of corporate governance quality (CGQ) provides comprehensive and robust evidence for the association between CGQ and stock liquidity in the pure order-driven Australia market. By using a large sample of 1207 firms from 2001 to 2013, we find a significant positive relationship between CGQ and stock liquidity, suggesting that better governed firms have greatly improved stock liquidity. Specifically, we find that better governed firms have a lower trading cost, smaller price impacts of trade, and higher trading speed. Moreover, the empirical results reveal that CGQ improves stock liquidity because it is associated with higher information disclosure.

## 1. Introduction

Stock liquidity continues to be a prominent research topic in the market microstructure literature, in particular since the recent global financial crisis (GFC). *Handa and Schwartz (1996)* stress that “Investors want three things from the markets: liquidity, liquidity and liquidity” (p. 44). Investors require compensation for holding an illiquid stock (*Amihud & Mendelson, 1986*) that increases the firm’s cost of equity (*Butler, Grullon, & Weston, 2005*), and in turn affects the firm’s value (*Fang, Noe, & Tice 2009*). Given that stock liquidity is crucial for both investors and firms, it is vital to investigate the antecedents of stock liquidity.<sup>1</sup> In particular, we aim to answer two key questions: Does corporate governance quality (CGQ) determine all stock liquidity dimensions? And does CGQ affect stock liquidity through information disclosure?

Classical studies emphasize the role of internal CGQ in determining stock liquidity. For example, *Coffee (1991)* argues that large investors support internal governance mechanisms because such mechanisms enhance stock liquidity that in turn makes exit less costly for them. Despite such an argument, there is scant empirical evidence on the linkage between internal CGQ and stock liquidity. For instance, *Chung, Elder, and Kim (2010)* show that the CGQ improves stock liquidity in the US. These findings, however, are limited to a short time-series (2001 to 2004) and coincide with the introduction of the Sarbanes-Oxley Act of 2002, which might have resulted in a spurious correlation between CGQ and stock liquidity. Those authors use high frequency quote-based liquidity proxies capturing trading cost and price impact dimensions, and antitakeover provisions are one of the key components of their governance index.<sup>2</sup> This casts a doubt on the generalizability of the results from the US to other countries, where anti-takeover provisions and high frequency quote-based liquidity proxies are non-existent. Other studies on CGQ and stock liquidity are conducted in emerging markets such as Malaysia (*Foo & Zain, 2010*), China (*Lei, Lin, & Wei, 2013*), Thailand (*Prommin, Jumreornvong, & Jiraporn, 2014*),

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E-mail addresses: [searat.ali@griffithuni.edu.au](mailto:searat.ali@griffithuni.edu.au) (S. Ali), [b.liu@griffith.edu.au](mailto:b.liu@griffith.edu.au) (B. Liu), [j.su@griffith.edu.au](mailto:j.su@griffith.edu.au) (J.J. Su).<sup>1</sup> A number of earlier studies identify stock and market characteristics (*Benston & Hagerman, 1974; Branch & Freed, 1977; Tinic, 1972*), and external governance environment (*Bacidore & Sofianos, 2002; Brockman & Chung, 2003; Chung, 2006; Eleswarapu & Venkataraman, 2006*) as a determinant of stock liquidity.<sup>2</sup> Their governance index is based on 24 provisions; 10 of them are related to anti-takeover.

France (Karmani & Ajina, 2012), and international markets (Chung, Kim, Park & Sung, 2012). Overall, these studies suffer from small samples and limited liquidity proxies or dimensions. For instance, Prommin et al. (2014) document that better governance improves stock liquidity over time in Thailand. However, their finding does not survive in the cross-sectional setting.<sup>3</sup> Moreover, they select only 100 large firms during a short period of time (2006 to 2009); thus, their findings may not be generalized to the wider economy.

Another important limitation of the prior studies on CGQ and stock liquidity is that these studies do not provide an empirical test of the channel through which CGQ affects stock liquidity. In theory, better CGQ increases stock liquidity by improving information transparency. In particular, better CGQ imposes more monitoring on managers and, therefore, prevents opportunistic managers from concealing and distorting information. Thus, better corporate governance improves the informational transparency of a firm and mitigates information asymmetry between insiders (e.g., managers) and outsiders (e.g., investors), as well as among outsiders. When information asymmetry is less severe, traders face fewer adverse selection problems (Glosten & Milgrom, 1985); hence, they provide more liquidity to stocks of well governed firms.

The importance of the stock liquidity and the limitations in the empirical literature motivate us to provide comprehensive and robust evidence on the governance–liquidity nexus. We take advantage of the recently available governance data of Australian firms through the Securities Industry Research Centre of Asia-Pacific (SIRCA) database, and use a large sample of 1207 non-financial Australian firms (10,179 firm-year observations) over the period from 2001 to 2013. We measure corporate governance by following the Horwath report methodology more relevant to Australian firms. The Horwath report places emphasis upon the quality of a firm's internal structures and processes (e.g., board structure, and subcommittees).<sup>4</sup> We measure stock liquidity by using three main dimensions including trading cost (i.e., time-weighted quoted spread [TWQS] and zero return measure [ZERO]), price impact of trade (i.e., Amihud illiquidity estimate [ILLIQ] and liquidity ratio [AMIVEST]), and trading frequency (stock turnover [STO] and turnover-adjusted number of zero daily volumes [LM]) that are calculated by using both high and low frequency data. To test the disclosure as a channel between CGQ and stock liquidity, we mainly measure information disclosure by counting the number of documents (total, price sensitive, and non-price sensitive) released by a firm at any time over the financial year.

The pooled ordinary least squares (OLS) results reveal a significant positive linkage between CGQ and stock liquidity for Australian firms. Moreover, we discover that the improvement in stock liquidity through CGQ is related to all three dimensions of stock liquidity. In particular, the improvement in corporate governance helps a firm to reduce the trading cost and the price impact of trade, and to increase trading frequency. These findings are robust to the inclusion of the industry effect, the year effect, and the firm characteristics, such as firm size, leverage, return volatility, asset tangibility, stock price, firm age and growth opportunities. The findings of our study are economically significant as well. For example, we show that an increase in CGQ from the 25th to the 75th percentile reduces the TWQS, ILLIQ, and LM by as much as 20.89%, 99.54%, and 30.39% respectively. These findings are stronger than the findings of Chung et al. (2010) in the US (4.5%). We also document that the relationship between CGQ and stock liquidity is unaffected by the use of high frequency or low frequency liquidity proxies. Therefore, the findings of our study provide comprehensive insights into the governance–liquidity nexus.

We then perform a variety of robustness checks to ensure that the main results are reliable. Specifically, we find that the main findings are robust to alternative estimation methods, such as a fixed effect (over time variation and omitted variable bias) and between estimators (cross-sectional variation). Further, we address the potential endogeneity bias by employing regressions based on one- and two-period lagged values of the independent variables, an instrumental variable approach i.e., two-stage least squares (2SLS), and a dynamic two-step system generalized method of moments (GMM). The results further confirm that even when the possible sources of endogeneity are controlled, better CGQ leads to greater stock liquidity.

Further, we empirically show that better governance improves stock liquidity because it is associated with a higher level of disclosure. Specifically, we find that corporate governance is positively related to disclosure, and disclosure is positively related to stock liquidity. Moreover, we document that corporate governance does not seem to be associated with a statistically significant better stock liquidity for low disclosure firms. However, corporate governance is found to sharply increase the stock liquidity of firms with high disclosure. Finally, we employ three-stage least square (3SLS) method and show that governance quality is associated with improved information environment and, hence, improves stock liquidity. These results, therefore, suggest that to improve stock liquidity, firms should adopt those governance provisions that enhance a firm's information environment.

We then perform several additional analyses and show that the main findings are robust to individual governance categories (board, audit, nomination, and remuneration quality), to the inclusion of ownership concentration, to additional information asymmetry variables (e.g., R & D and Big4 Audit), and to alternative proxy of disclosure (i.e., timeliness of price discovery) in the model.

We contribute to the literature in several ways. First, Australia possesses a distinctive regulatory and institutional framework that casts a doubt on the generalizability of results from the US to the Australian market (see e.g., Méndez, Pathan, & García, 2015; Monem, 2013). For instance, Australia has a pure order-driven trading system where public limit orders establish bid–ask prices and provide liquidity to market participants. On the contrary, the US has a quote-driven market where the designated market makers quote the bid–ask prices and supply liquidity to the market. Brown and Zhang (1997) argue that the liquidity is high in markets that

<sup>3</sup> Corporate governance provisions of large firms do not vary much. As can be seen in their summary statistics (Table 2), the governance index is 6 in the 25th percentile, 7 in the 50th percentile and 8 in the 75th percentile. This may be the reason that they have not found significant cross-sectional variation between governance quality and stock liquidity.

<sup>4</sup> This report pays special regard to the CG mechanisms that are identified as important in Australian and international CG best practice codes (US Blue Ribbon Committee Report 1999 [The Business Lawyer 1999]; Australian Securities Exchange (ASX) Principles of Good Governance and Best Practice Recommendations 2003 [ASX CG Council 2003]; the Organization for Economic Cooperation and Development (OECD) Report 2004).

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