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Company responses to exchange queries in real time

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ABSTRACT

We examine the efficacy of exchange queries in assisting to explain anomalous trading behaviour in a timely manner. Using intraday data for a sample of liquid stocks, we find consistent price reversals after firms respond to the query by labelling the pre-announcement trading activity as unsubstantiated. The information contained in this unanticipated announcement is impounded within 20 minutes, preceded by a transition period of heightened trading intensity, wider spreads and shifting order book depth. Overall, this study finds that queries enhance the orderly flow of information and reduce information asymmetry. Exchanges in other countries should consider their use.

1. Introduction and motivation

It is not uncommon to observe abnormal stock price fluctuations without a specific event such as a surprise company announcement, an unanticipated regulatory decision or news relating to a failed transaction acting as a trigger. That is, share price volatility can occur in the absence of a public event that would explain and rationalise the reaction of market participants. Such trading behaviour could be the result of large investors speculating on the future prospects of the firm or informed traders deciding to take advantage of information asymmetry. Whatever the cause, an unexplained share price movement can lead investors to attempt to infer information that does not, in fact, exist.

Despite this, an overwhelming majority of equity exchanges around the world do not employ a mechanism designed to identify and explain ambiguous price variation in a timely manner. Instead, exchanges commonly rely on continuous disclosure legislation to motivate public corporations to immediately disclose price sensitive information that can affect trading. Within many markets, there is no structured method of promptly and directly communicating concerns regarding unjustified security price variation between the exchange and the listed firm (Thompson, 2007). Singapore, New Zealand and Australia are the exception. For data reasons, we focus our analysis on the latter.

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In addition to continuous disclosure rules, the Australian Securities Exchange (ASX) uses a standardised set of four questions to probe listed firms whose recent equity fluctuations cannot be explained by publicly available information. That is, there is no firm-specific, industry-level or market-wide information available to the exchange surveillance group searching for a reasonable explanation via, for example, news releases, analyst reports, investor forums, chat sites, company announcements or competitor disclosures to substantiate the share price change. The period of concern is typically a single trading day but can be as long as a few weeks in rare circumstances. These questions ask companies if they are aware of any explanation for the unusual price or volume changes and to acknowledge their compliance with all disclosure regulation.[1] This submission is done privately and the company is typically given one trading day to respond (most respond within a few hours) in order to avoid an automatic trading halt. Once a response is received, both it and the initial exchange query are released to the market at the same time without any prior notice.

While the exchange is likely to have a predetermined range of stock volatilities that warrant a query, the ASX does not publicise these trigger levels, obscuring attempts to anticipate the event and front run. That is, investors are not aware of the specific screening criteria used in issuing these requests, nor are they able to infer the content or exact timing of the response, causing queries to be unanticipated disclosures. The majority of replies involve companies denying any knowledge of information that would explain the abnormal trading activity that caused the query (a 'no news' reply). Hence, if this query regime is operating as intended, then labelling the prior stock price increase (or decrease) as unjustified should result in a significant price reversal.[2]

This paper examines the performance of the query framework as a supplement to continuous disclosure requirements. The extra layer of scrutiny introduces monitoring costs for the exchange and the queried firms not borne by the majority of their international peers. The question is, what are the benefits? We are motivated by the scarcity of research regarding the use of queries to curtail unexplained share price volatility in a timely manner and reduce situations where the market is trading on an uninformed basis. Further, this study aims to overcome the constraints highlighted by the existing literature and provides additional tests of the query process in adding value-relevant information to the equity market. It is rare for equity exchanges to readily publish correspondence they have with the listed entity. Hence, the query regime operated by the ASX also allows us to conduct a natural experiment on this unique subset of public announcements.[3]

The paper most related to ours, Drienko and Sault (2013), tests the impact of intraday queries over a two-year period of recent announcements. The authors find that unexplained share price increases are reversed by −1.1% and unexplained decreases are reversed by 2.0% within 60 minutes of a no news reply. This, the paper argues, shows that queries are noted and acted upon by market participants.

Our study differs from the available literature in a number of important respects. First, our sample includes only the most liquid stocks in order to overcome the illiquidity and outlier concerns present in Drienko and Sault (2013). Illiquid stocks with significant transaction costs are often difficult to trade at efficient prices, hindering the ability of investors to impound news as they would otherwise desire. Such frictions can contaminate empirical tests designed to assess the size and scope of market reactions to price sensitive announcements. The authors themselves caution that the bulk of their sample is composed of small stocks with limited liquidity and that their results should be interpreted as the lower bound of the speed with which prices respond to query announcements. By isolating our analysis to frequently traded stocks, we are able to find the upper bound.

Second, we study the return and volume impact of query announcements with finer granularity. Shorter event intervals of 10 minutes in length (spanning from [−60 min, −50 min] to [+50 min, +60 min]) allow our study to more accurately estimate the points at which prices adjust to new information as well as reduce unwanted noise in the sample. Third, we sample all available query announcements from the onset of the database (1998 onwards), as opposed to arbitrary periods examined previously. In doing so, we are able to restrict the overlap with prior research and provide new evidence that the use of queries rises in times of heightened volatility in the equity market. Our results suggest that queries can provide exchanges with a useful mechanism to reduce mispricing and informational asymmetry in periods of unrest within financial markets.

Finally, we are the first to consider the effect of queries on market liquidity of event firms (i.e., spreads and depth), examine the trading activity in pre-announcement periods, use novel benchmarks in calculating abnormal returns (propensity score,

[1] This is an example of a trading induced query, the use and design of which is detailed in the ASX Listing Rules 3.1, Guidance Notes 8.1–8.3. Such queries are employed only when the exchange detects abnormal trading in the absence of public information that would substantiate such trading on a real time basis. We do not examine technical queries that are idiosyncratic and largely tailored to the firm in question. Such queries are not standardised and, therefore, cannot be pooled as homogenous observations into a functional data set.

[2] Within our sample: 89% of responses are no news replies; 5% of responses provide investors with new data with which to update their information sets; and, 6% of responses involve firms declining to answer, citing an exemption due to confidentiality reasons and the presence of information that is premature to disclose. Refer to Appendix A for an example of a no news reply to an exchange query and Appendix B for an example of a confidentiality exemption to an exchange query.

[3] Note that the continuous disclosure regulation (ASX Listing Rules 3.1) and the issuance of queries do not apply to proprietary information, trade secrets and details generated for internal management purposes. In such circumstances, a company subject to a query would reply by stating that there is no new information that should be disclosed.

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