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Anonymity and order submissions

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ABSTRACT

We investigate the effect of the removal of broker identities on institutional and individual order submissions on the Australian Stock Exchange (ASX). We document declines in order aggressiveness and effective spreads for both institutional and individual investors after the switch to the anonymous trading system. Institutions are more willing to improve the best quotes than individuals, especially in the anonymous market. Anonymity also reduces the “picked off” risk for individual limit orders. Overall, our findings highlight the benefits of withholding brokers' IDs in the form of lower transaction costs and higher liquidity supply and thus support the ASX's decision to stop disclosing broker identity information.

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1. Introduction

This study investigates the impact of removing broker identities (broker IDs) on investors' order submissions on the Australian Stock Exchange (ASX). More specifically, it examines the changes in the order submissions of institutional and individual investors to determine their willingness to supply liquidity and to improve the best quotes after the switch to an anonymous trading system. Building from these findings, we further analyze how anonymity affects trading costs and informativeness of institutional and individual orders.

In contrast to the common belief that increasing market transparency improves market quality (see, for example, Glosten, 1999; Madhavan, 1996; Pagano and Roell, 1996), the current trend is for equity markets to remove broker IDs and switch to anonymous trading systems.[2] This trend provides the motivation for

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[2] For example, the Euronext Paris, the Tokyo Stock Exchange, and the ASX removed broker IDs on April 23, 2001, June 30, 2003, and November 25, 2005, respectively.

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examining the effect of anonymity on investors' order submissions. More specifically, analysis of the changing behavior of institutional and individual investors in different market transparency regimes provides a better understanding of investors' demand and supply of liquidity in response to a reduction in market transparency. Since the main motivation for the ASX to remove broker IDs was to improve market liquidity (ASX, 2005), the findings in this paper provide evidence regarding the effectiveness of the switch to an anonymous trading system and can help market regulators design a market mechanism to enhance overall market liquidity. Given that liquidity plays an important role in attracting traders (Harris, 2003), our findings can also serve regulators and exchange officials in designing a more competitive stock market.

Prior to November 28, 2005, the ASX disseminated, in real time, the broker ID coupled with every order in the central limit order book for each security traded. The broker ID information associated with individual orders and trades was only disseminated to the broker community during the regime of market transparency. Although the release of broker ID information to third parties was strictly prohibited, the ASX (2005) acknowledges that there were constant breaches of the confidentiality agreement. This created an information advantage for those investors using full advisory brokering services over those making their own trading decisions (ASX, 2003).

On November 28, 2005, the ASX ceased providing broker IDs to the broker community in real time and since provides only market share information at the end of the trading day and releases the full trading history with broker IDs after a delay of three days. The foremost reason the ASX stopped disclosing broker IDs is that this practice fosters front-running activities, which suppress liquidity and impose extra costs on investors. This results in investors seeking execution outside the central market (the limit order book), which, in turn, impairs overall market liquidity (ASX, 2005).

Foucault et al. (2007) develop a theoretical model for limit order markets to explain the changing aggressiveness of informed and uninformed traders after the removal of broker IDs. In a transparent market uninformed traders infer information about future price movements from observing the quotation behavior of informed traders. These uninformed traders try to front-run the informed traders by setting more competitive quotes. Informed traders respond by sometimes engaging in "bluffing" strategies, posting non-aggressive orders and setting wider spreads than appropriate. In an anonymous trading system, uninformed traders cannot distinguish the informed traders' orders from those of uninformed traders. They submit orders based on their belief about the identity of the traders in the limit order book. In this case, if the participation rate of informed traders is low, then uninformed traders will be more aggressive and improve on the already posted orders more often. On the other hand, if the participation rate of informed traders is high, uninformed traders will be less aggressive and less willing to improve existing orders.

Prior studies often test the Foucault et al.'s (2007) model by analyzing the effect of anonymity on the bid–ask spread (see, for example, Comerton-Forde et al., 2005; Comerton-Forde and Tang, 2009; Foucault et al., 2007); limit order book information (Foucault et al., 2007); adverse selection risk, order exposure risk, and order aggressiveness (Comerton-Forde and Tang, 2009). We differ from these studies by making the distinction between institutional and individual investors in our analysis of the effect of anonymity on order aggressiveness; the willingness to improve the best prevailing quotes; trading costs and order informativeness. The distinction between institutional and individual orders is important since these two classes of investors potentially differ in their possession of private information (see, for example, Alangar et al., 1999; Chakravarty, 2001; Dennis and Weston, 2001; Szewczyk et al., 1992). Moreover, individual investors constitute an important investment group in Australia, with 55% of the adult Australian population owning shares. In terms of market value, individual investors possess at least 22% of the Australian equity market and their trading activities account for about 51% of the market turnover as measured by the number of transactions (D'Aloisio, 2005).

We contribute to the literature on anonymity by showing whether the benefits of anonymity, such as a reduction in bid–ask spread (see, for example, Comerton-Forde et al., 2005; Comerton-Forde and Tang, 2009; Foucault et al., 2007) or an improvement in liquidity supply (see, for example, Comerton-Forde and Tang, 2009), are due to the actions of institutional or individual investors. Drawing on the insights of Foucault et al. (2007), we argue that if anonymity reduces front-running activities and the incentive for better-informed (institutional) investors to submit "bluffing" limit orders, institutions will be less aggressive in their order submissions and their limit orders will be more informative after the removal of broker IDs. For individual investors, the move to anonymity reduces the ability of other traders to distinguish their orders and those submitted by institutional investors (i.e.: reduced "picked-off" by better-informed investors). Thus, individual

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