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journal homepage: www.elsevier.com/locate/jfecExchange trading rules and stock market liquidity[☆]Douglas Cumming^{a,*}, Sofia Johan^{a,b}, Dan Li^a^a York University, Schulich School of Business, 4700 Keele Street, Toronto, Ontario, Canada M3J 1P3^b University of Tilburg, Tilburg Law and Economics Centre (TILEC), Postbus 90153, 5000 LE Tilburg, The Netherlands

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ABSTRACT

We examine stock exchange trading rules for market manipulation, insider trading, and broker–agency conflict, across countries and over time, in 42 stock exchanges around the world. Some stock exchanges have extremely detailed rules that explicitly prohibit specific manipulative practices, but others use less precise and broadly framed rules. We create new indices for market manipulation, insider trading, and broker–agency conflict based on the specific provisions in the trading rules of each stock exchange. We show that differences in exchange trading rules, over time and across markets, significantly affect liquidity.

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1. Introduction

Stock exchanges around the world invest considerable manpower, technological effort, and financial resources to curb market manipulation and promote market efficiency and integrity (Aitken and Siow, 2003; Avgouleas, 2005; Comerton-Forde and Rydge, 2006). It is widely regarded that securities law (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998; La Porta, Lopez-de-Silanes, and Shleifer, 2006; Jackson and Roe, 2009) and market microstructure (Harris, 2002; Harris, Aitken, Cook, and McInish, 2009) play an important role in the development of stock markets around the world. Despite these important developments in the literature, a dearth of attention has been paid to the differences across exchanges with respect to the treatment of market manipulation within their trading rules.

In this paper, we show international differences in trading rules for stock or equity exchanges, and we examine the impact of market integrity rules on the

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performance of equity marketplaces. Specifically, we study the differences in regulation across 42 exchanges worldwide during the time period of 2006–2008 and then proceed to investigate whether integrity-related exchange trading rules matter for market liquidity. For the purposes of this article, trading rules refer to the rules and regulations that regulate the activities within a stock market and the conduct of its participants, namely, the exchange and the members of the stock exchange who agree to be bound by such rules and regulations.

We create new indices for trading rules pertaining to market manipulation, insider trading, and broker–agency conflict for these 42 stock exchanges in both developed and emerging markets. For the purposes of this article, market manipulation refers to the trading practices that distort prices and enable manipulators to profit at the expense of other market participants. Insider trading refers to acting on material nonpublic information. Broker–agency conflict refers to the actions that brokers could take while acting as the agent of a client that benefits the broker (or some other affiliated party) at the expense of the client or the market more generally. Some stock markets such as Nasdaq have extremely detailed rules that explicitly prohibit specific manipulative practices and broker–agency conflict, as well as rules that are designed to curtail the presence of insider trading. For example, Nasdaq's rules provide detailed provisions regarding wash trades, pre-arranged trading, fictitious orders, giving-up priority, churning, front-running, and a variety of other types of practices that constitute market manipulation. Other exchanges are less precise and have broadly framed rules regarding what constitutes market manipulation or broker–agency conflict.

In view of the significant differences in the way trading rules regulate market manipulation, insider trading, and broker–agency conflict across countries and over time, it is worth considering whether these differences matter. To this end, in addition to showing the differences in trading rules and developing new indices of market surveillance, we examine whether the differences in trading rules can help to explain the differences in liquidity among exchanges. Specifically, we examine whether a correlation between trading rules exists and a series of liquidity measures that include velocity, volatility, and relative bid–ask spread. The primary function of a marketplace is to provide liquidity to market participants. The effectiveness of an exchange is affected by its rules that regulate security transactions. We consider two competing hypotheses regarding the impact of trading rules on liquidity. On the one hand, one can argue that vague regulations create inefficiency as investors and traders are not clear as to which activities are acceptable and which ones are in breach of the rules. Detailed rules, therefore, could give rise to greater investor confidence, provide greater dissemination of knowledge about prohibited conduct, and facilitate invigilation of such rules, which in turn might reinforce investor confidence in the marketplace. As a result, these rules might help to improve trading activity, reduce uncertainty, and decrease trading cost. On the other hand, one could argue that detailed regulations create inefficiency as investors and traders are able to take

advantage of inevitable loopholes and, if so, more detailed exchange rules could have a negative effect on liquidity.

Although exchanges do not amend their rules very frequently, amendments to rules are instituted over time. Most notably for European exchanges, in November 2007 the Directive on Markets in Financial Instruments (MiFID) became effective and thereby gave rise to more detailed rules and more transparent investor protection for the European exchanges. Although some European exchanges, such as the London Stock Exchange, already had in place trading rules that were analogous to the new rules in MiFID, others such as the Austrian exchange had significantly less detailed rules prior to MiFID. Because the introduction of MiFID affects only the countries of the European Union, it creates a natural experimental setting in which to assess the impact of exchange rule restrictions on trading activity. In this article, we exploit this setting to shed light on our research question by examining the dynamics of the market liquidity measures between the two groups of exchanges around the introduction of MiFID. Because MiFID is introduced as a major part of the European Union's Financial Services Action Plan (FSAP) instead of as a result of one single jurisdiction's need to improve regulation, endogeneity issues that relate rule changes to market outcomes are minimized in our experimental setting.

The data presented in this article show a strong and robust effect of trading rules on liquidity. Detailed trading rules are positively associated with velocity and negatively associated with volatility and bid–ask spreads. We show this effect with panel data that vary across time and countries by considering a variety of robustness checks that include, but are not limited to, fixed effects modeling and difference-in-differences tests. To isolate the influence of the trading rules, we also control for a number of plausible factors that could effect trading activity based on prior academic works, including exchange institutional features (Röell, 1992), market microstructure aspects (Stoll, 2000), and international differences in securities regulation (La Porta, Lopez-de-Silanes, and Shleifer, 2006; Jackson and Roe, 2009), among other things. The effect of rules on liquidity is robust to controls for economic, legal, and institutional differences across exchanges that might have been correlated with country specific differences in the drafting of trading rules. This strong evidence is due to the fact that exchanges that specifically recognize and prohibit certain acts in the marketplace enhance investor confidence. As well, exchanges with more specific rules invariably have residual catch-all clauses that explicitly outline the spirit of the rules and regulations and prohibit a vaguely defined "any other type of manipulative activity" such that (arguably) there is scant scope for exploiting potential loopholes.

A few recent articles are closely related to our own. La Porta, Lopez-de-Silanes, and Shleifer (2006) and Jackson and Roe (2009) show that securities law matters for facilitating stock market development in 49 exchanges around the world. Aitken and Siow (2003) provide a ranking of exchanges based on efficiency and integrity. Cumming and Johan (2008) provide survey evidence that surveillance technology and information sharing facilitate market integrity. Hail and Leuz (2006), Daske, Hail, Leuz, and Verdi (2008) and Lampert, Leuz, and Verracchia

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