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International trade-venue clienteles and order-flow competitiveness

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Abstract

This paper tests a generalized version of the investor clientele hypothesis of Amihud and Mendelson [J. Finan. Econ. 17 (1986) 223]. This international trade-venue clientele effect hypothesis is supported for the Canadian cross-listed firms undifferentiated and differentiated by US trade venue, except for TSE shares cross-listed on NASDAQ. The hypothesized relationship between relative holding periods (measured using shares outstanding and share float) and effective half-spreads changes after TSE decimalization, and differs if the cross-listed shares have options traded on them. The empirical findings suggest that the TSE lost (won) executed order flow relative to the AMEX and to NYSE for shares with (without) options traded on them.

JEL classification: G14; G15

Keywords: Clienteles; Order-flow competitiveness; Bid–ask spreads; Share float; Decimalization; International financial markets

1. Introduction

Amihud and Mendelson (1986) theoretically demonstrate that shares with higher bid–ask spreads are held for longer periods than shares with smaller spreads, all else held equal. This theoretical inference is supported by the finding of Atkins and Dyl (1997) that holding periods are positively associated with the size of the quoted bid–ask spread for NASDAQ

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and NYSE stocks. A generalized Amihud and Mendelson hypothesis, referred to herein as an *international trade-venue clientele effect*, is the focus of this paper which empirically examines this generalized hypothesis for a sample of Canadian firms cross-listed on the Toronto Stock Exchange (TSE) and various US trade venues.[1] This generalized hypothesis states that, in equilibrium, same-firm shares with increasing *relative* spreads across trade venues are held in portfolios with the same or expected increasing relative holding periods, and vice versa for decreasing relative spreads. Thus, a decrease in relative trade costs as measured by the effective spreads for the same-firm shares in favor of the US versus say the Toronto trade venue is expected to result in a decrease in the relative holding period or increase in the relative volume turnover on the US trade venue relative to that on the TSE.

The existence of an international trade-venue clientele effect implies a possible win-lose situation for the market shares for order-flow execution across trade venues. A smaller ratio of the holding periods between the US trade venue and the TSE for the same-firm cross-listed shares implies that trading volume or share turnover has increased on the US trade venue relative to that on the TSE. In turn, this change normally is associated with a higher decrease or lower increase in effective spreads on the US trade venue relative to the lower decrease or higher increase in effective spreads on the TSE. If the synchronized increase (decrease) in the ratio of holding periods for the shares cross-listed on the US trade venue and the TSE is associated with a synchronized increase (decrease) in effective spreads for the same-firm shares on the US trade venue and the TSE, no international trade-venue clientele effect occurs. This would suggest that markets are becoming highly competitive, and that the differentials in trade costs and holding periods across trade venues will tend to disappear. In turn, this would lead to the full integration of the Canadian and US stock markets.[2]

Related to the generalized hypothesis is the issue of the impact of the TSE decimalization on order-flow execution and trade-venue clientele behavior. Since an objective of the TSE decimalization, which occurred on April 15, 1996, was to implement a minimum quotation increment reduction (MQIR) in order to increase TSE trading volumes relative to that on competing trade venues, this event is expected to have an impact on the relative market shares of trade venues competing for the order flow of our sample of Canadian cross-listed shares.

A third issue is the impact of options trading on internationally listed same-firm shares. Various studies reviewed by Damodaran and Subrahmanyam (1992) and Coughenour and Shastri (1999) find that option trading decreases information asymmetry and enhances market efficiency for the underlying shares. In turn, all else held equal, the decrease in information asymmetry should lower bid–ask spreads. Lower bid–ask spreads should themselves be associated with shorter holding periods.

The above discussion raises three questions that are addressed in this paper:

[1] To be consistent with the literature and given that the change occurred after our sample period, we do not use the new names for the TSE and TSE300 index (namely, the TSX and S&P/TSX Composite, respectively) throughout this paper.

[2] Important studies on stock market integration between Canada and the US include Jorion and Schwartz (1986), Mittoo (1992), and Koutoulas and Kryzanowski (1994).