



# Firm opacity and financial market information asymmetry<sup>☆</sup>



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## ABSTRACT

Information asymmetry could exist between the firm and the investors as well as among investors. If the information asymmetry between the firm and the investors is very high, all investors are largely uninformed, so information asymmetry between investors should be low. At the other extreme, if all investors are fully informed about the firm, again the information asymmetry between investors should be low. This paper finds evidence supporting such a nonlinear relationship between firm-to-investor and investor-to-investor information asymmetry. The inter-investor information asymmetry increases, and then declines, as the information asymmetry between the firm and the investor increases.

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## 1. Introduction

Information asymmetry between the firm and the investor affects the functioning of an efficient capital market (Healy and Palepu, 2001). Considerable resources have been devoted by the regulators to enact and enforce new disclosure policies (such as Regulation Fair Disclosure) aimed at reducing information asymmetry between the firm and the investor. An implicit expectation is that these regulations will reduce information asymmetry among investors in the financial market making it more fair and efficient. This last statement assumes a monotonic relation between the two types of information asymmetries. However, extant theoretical studies cast some doubt on this assumption.

Some researchers (Diamond, 1985; Hakansson, 1977) find that reduction in firm-to-investor information asymmetry (hereafter referred to as firm-to-investor-IA) leads to reduction in the expected net benefit to investors with private information, thereby lowering their incentive to find the information in the first place. Thus, lower firm-to-investor-IA should imply a lower risk of trading with an informationally-endowed trader. This reduces the level of inter-investor-information asymmetry (hereafter referred to as inter-investor-IA). However, other studies (Kandel and Pearson, 2005; Kim and Verrecchia, 1994; Lundholm, 1991) suggest that greater quantities of and better quality information released by a firm provide more material to those investors who attempt to process public signals in order to create private benefits. If this is the case, then lowering

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firm-to-investor-IA may result in higher inter-investor-IA. Given the differing views, it is not clear whether a reduction in one would lead to a decrease or an increase in the other.

Since theoretical arguments alone cannot unambiguously predict the relationship between firm-to-investor-IA and inter-investor-IA, we look towards empirical research for some guidance. Most of the disclosure literature (Brown and Hillegeist, 2007; Healy et al., 1999; Heflin et al., 2005; Welker, 1995) find a negative relation between disclosure quality and information asymmetry among investors, as proxied by various measures of the bid–ask spread. Brown and Hillegeist (2007) argue that this negative relationship exists because improved disclosure quality acts as a disincentive for investors searching for private information, and therefore it reduces the probability of trading with informed traders in the market. This view is consistent with the first of the two theoretical views outlined above (Diamond, 1985; Hakansson, 1977). However, evidence from another set of studies, which includes Lee (1992), Lee et al. (1993), Krinsky and Lee (1996), Huson and MacKinnon (2003), Ke and Ramaligegowda (2005), and Desaia and Savickas (2010), suggests a positive relation between disclosure quality and information asymmetry among investors.

Huson and MacKinnon (2003), while studying the effects of focus enhancing spinoffs on inter-investor-IA, find that the information asymmetry among investors increases post spinoff. To the extent that a focus-enhancing spinoff leads to reduction in firm-to-investor-IA, their evidence supports the second theoretical view outlined above (Kandel and Pearson, 2005; Kim and Verrecchia, 1994; Lundholm, 1991). Desaia and Savickas (2010) draw a similar conclusion from their evidence that the idiosyncratic volatility for parent firms increased after spinoffs and equity carve-outs. Exploring the post earnings announcement adverse selection cost of trading (a measure of inter-investor information asymmetry), Lee et al. (1993) and Krinsky and Lee (1996) find that, on average, the adverse selection cost component of the bid–ask spread increases significantly after earnings announcements. Similar evidence has also been found in studies of post earnings announcement drift trading strategies. Ke and Ramaligegowda (2005) document that the “transient” institutions that arbitrage drift can trade on their ability to quickly process public disclosures into tradable private information. Their findings suggest that differential private information can be created from public disclosures by investors with better processing ability. Thus, once again, the extant research leaves us with differing views on the relationship between firm-to-investor-IA and inter-investor-IA.

We attempt to reconcile the two diverging views by proposing a unimodal relation between the two types of information asymmetries. This proposal draws its intuition from the theoretical model of Kim and Verrecchia (1991). Our contribution here is to provide empirical evidence of a nonlinear and concave relation between the two types of information asymmetry that potentially synthesizes seemingly conflicting extant research.

This line of reasoning is primarily motivated by Kim and Verrecchia (1991)'s work on the relation between the precision of public announcement and inter-investor-IA. At one extreme, if the precision of the public announcement is low, disclosure causes little expectation revision and thus few opportunities to trade. Consequently, there is little (additional) incentive for investors to acquire private information in anticipation of a public announcement, so that information asymmetry across investors remains small. At the other extreme, suppose that the precision of the public announcement is high. Here, the disclosure is of sufficient magnitude to shock previous beliefs and price equilibrium. Hence, no opportunities are created for investors to trade. Again, there is little (additional) incentive for investors to acquire private information, and therefore information asymmetry across investors becomes small. Between these two extremes, the impact of the public announcement is sufficiently large to create opportunities to trade, but it does not eliminate uncertainties to cause all beliefs and price to converge. Thus, information asymmetry across investors becomes substantial. Therefore, according to this model, information asymmetry across investors increases as the precision of the public announcement increases up to some point, and steadily decreases thereafter (that is, its behavior is unimodal).

We test this prediction using a sample of over 1000 firms listed on NYSE from January 1993 to December 2008 and find evidence in support of this hypothesis. As firm-to-investor-IA increases, inter-investor-IA increases up to some point, and steadily decreases thereafter. This result is intuitively appealing. If a firm is completely transparent, all market participants would know everything about the firm, hence, the inter-investor-IA should be zero.<sup>3</sup> If the firm is completely opaque, all participants are uninformed, hence, the inter-investor-IA should be close to zero. Somewhere between the two extremes, the information asymmetry between investors attains a maximum.<sup>4</sup>

The result of this study has implications for a firm's transparency and disclosure-related policies. A marginal increase in the level of transparency of a firm with very high firm-to-investor-IA could lead to an increase in its inter-investor-IA. This might lead to reduced liquidity and possibly to a higher cost of capital (Amihud and Mendelson, 1988). The results suggest that increased firm transparency might not necessarily be always advantageous to the average investor in the market. Thus, this study adds to the literature on corporate disclosures policies. Furthermore, by pointing to a nonlinear relationship between firm-to-investor-IA and inter-investor-IA, this study also provides a cautionary note to anyone using microstructure based information asymmetry measures to proxy for firm-to-investor-IA.

<sup>3</sup> A transparent firm is one with low to nil firm-to-investor-IA. As the level of firm-to-investor-IA declines, firms will become less transparent (or more opaque). This paper uses transparency and firm-to-investor-IA synonymously. Opacity is the antonym of transparency.

<sup>4</sup> A caveat is in order here. At the two extremes, the level of inter-investor-IA will be determined through the interplay of search costs associated with obtaining private information and the economic value of the obtained private information. Therefore, the level of inter-investor-IA might be non-zero.

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