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The use of undisclosed limit orders on the Australian Stock Exchange

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Abstract

This paper investigates the use of undisclosed limit orders on the Australian Stock Exchange (ASX). Our findings suggest that undisclosed limit orders are used to reduce the option value of limit orders. We find no evidence that undisclosed limit orders are more frequently used by informed traders than disclosed limit orders. The effects of recent changes in undisclosed order regulation are also examined. We find that the enhancement in pre-trade transparency, through tightening the undisclosed order regulation in October 1994, resulted in a significant decline in trading volume. The impact of the second regulation change in October 1996, which further tightened undisclosed order regulation, resulted in a less significant trading volume reduction. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Exchanges that adopt electronic order book systems rely on limit orders as the major source of liquidity. Some markets, for example, the Australian Stock Exchange (ASX), the Paris Bourse and the Toronto Stock Exchange, give traders the option to hide the quantity of their limit orders and display price only. This study investigates the factors that affect the use of these 'undisclosed limit orders' on the ASX. The effect of recent changes in undisclosed order regulation is also examined.

Aitken et al. (1996) report that in 1993 about 6% of orders on the ASX, accounting for approximately 28% of volume, was undisclosed. Why do traders use undisclosed limit orders (ULOs)? According to some market participants ULOs are sometimes used by informed traders. Their reasoning is based on the idea that the more private information a trader possesses, the greater the incentive to hide his identity and trading intentions. [1] Informed traders might therefore prefer undisclosed over disclosed limit orders (DLOs) as the former provides a lower degree of pre-trade transparency.

An alternative explanation for the use of ULOs comes from Harris (1996). He argues that undisclosed limit orders are used as a defensive strategy against quote-matchers. [2] Limit order submitters face the risk that other traders take advantage of the trading options implicit in exposed limit orders. For example, if a large order to buy a stock is entered at a certain price, a quote-matcher might place a buy limit order at a slightly higher price. If his limit order is hit and the stock value subsequently rises, the quote-matcher will profit to the full extent of the rise. If the stock price falls, the quote-matcher may be able to limit his loss by selling to the large order. A defensive strategy against quote-matchers is to hide the quantity of limit orders. ULOs increase the trading risk borne by quote-matchers by creating uncertainty over the size of the 'safety net'.

Another problem that could be less severe for ULOs is what has been referred to as the 'sitting duck' or free option problem of limit orders. The free option problem exists because monitoring costs and delays in cancellation and execution prevent investors from continuously updating their limit orders for changes in market conditions. Limit orders are therefore exposed to the arrival of adverse new public information and might get unfavourable execution (see Berkman, 1996). Undisclosed orders do not remove exposure of orders to new

[1] For related theoretical papers see, for example, Admati and Pfleiderer (1991) and Forster and George (1992).

[2] Other papers that consider traders' order submission strategies are Kumar and Seppi (1994), Chakravarty and Holden (1995), Keim and Madhavan (1995), Handa and Schwartz (1996), Harris and Hasbrouck (1996) and Harris (1997).

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