

Removing constraints on minimum lot size benefits stock exchanges and investors

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Stock exchanges that remove constraints on their minimum lot size or Minimum Trading Unit (MTU) increase retail trader participation and reduce transaction costs, according to new research from the University of Bath's School of Management.

Whilst most European stock exchanges now have a MTU of one share, a number of important stock exchanges, including the NYSE, the NASDAQ and the Tokyo Stock Exchange, still set higher MTUs, which are decided at the discretion of the exchanges or, in some instances, by the issuing companies.

Researchers from Bath, along with the Warwick Business School and Bocconi University, studied the impact on market quality of reducing the MTU to one share at the Italian Stock Exchange, the Borsa Italiana, in 2002.

Their findings, published in *Financial Management* show that the change in the MTU resulted in a substantial improvement in liquidity. Notably, the relative bid-ask spread decreased, on average, by 10.2 per cent in the month after the event.

The liquidity improvement was sustained in the following months and was more significant for stocks with a higher volume of trading at a size equal to the MTU before the MTU reduction.

The researchers also documented an increase in retail trading

participation around the MTU change, as measured, among other methods, by a 16 per cent increase in online trading in the month after the reduction. They interpret their results in light of a theoretical model where market participants have different levels of private information and the MTU affects traders' choice of order size.

Dr Perotti, lecturer in Accounting & Finance, said: "Constraints on the MTU may facilitate exchange operations. However, removing these constraints encourages the participation of retail traders who would not be able to trade at a size larger than the MTU. As a consequence of the increase of trading by retail investors, which is unrelated to private information, adverse selection costs decrease and liquidity increases.

"Our results inform market regulators and participants on how the MTU design may affect market quality. The topic is particularly relevant because the average transaction size significantly decreased in recent years. Stock exchanges with MTU constraints may consider our results as strong evidence supporting a decision to remove or weaken the constraints."

Professor Arie Gozluklu, from Warwick Business School, added: "The evidence from the Italian market shows that [stock exchanges](#) are better off removing a trading constraint imposed on retail traders with a limited budget. Thus, exchanges will allow a wider participation to the stock [market](#) in a fair [trading](#) environment."

More information: Arie E. Gozluklu et al. Lot Size Constraints and Market Quality: Evidence from the Borsa Italiana, *Financial Management* (2015). [DOI: 10.1111/fima.12105](https://doi.org/10.1111/fima.12105)

Provided by University of Bath

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