The Effect of Minimum Order Limits On Share Liquidity and Prices

Shmuel Hauser & Yael Tanchuma

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Abstract

In September 1998, a decision was made to increase the minimum trading unit and in December 2000, a decision was made to reduce the minimum trading unit in the RATZIF stage of trading on the TASE. In this study we examine the effect of these changes on share liquidity and share prices. We examine two hypotheses. According to the first, following Merton (1987) and Amihud, Mendelson and Ono (1999), reducing the minimum trading unit should have a positive impact on share liquidity and share prices, as reducing the minimum trading unit is expected to increase the investor base in these shares, leading to a rise in liquidity, a decline in the cost of capital, and a corresponding increase in share prices. The second hypothesis is that the effect of reducing the minimum trading unit is also dependent on share liquidity. In other words, reducing the minimum trading unit has a positive (negative) effect on shares whose liquidity was originally high (low); increasing the minimum trading unit has an inverse effect. One explanation is that reducing the minimum trading unit causes two countervailing effects: On the one hand, it allows single investors to increase the number of share they include in their portfolio, leading to greater diversification of their investors, which reduces the risk premium that investors demand, and results in higher share prices. On the other hand, a potential decline in liquidity and rise in share volatility have a negative impact on share prices. According to this hypothesis, when the shares are very marketable, the first factor has a dominant effect on share prices. The empirical findings support this hypothesis and point to the problem in treating all shares similarly, and to the need to assess the potential effects of changes in trading rules in view of differences in share liquidity.

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