

Investor protection, adverse selection, and the probability of informed trading

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Abstract The purpose of this study is to investigate the relation between investor protection, adverse selection, and the probability of informed trading. Previous research has established a direct relation between investor protection and firm liquidity, measured by bid-ask spreads and depths. In this study, we test the hypothesis that adverse selection is the mechanism through which poor investor protection leads to higher costs of liquidity. The Hong Kong equity market provides a unique opportunity to compare adverse selection differences across distinct investor protection environments, holding constant the trading platform and currency. Using various bid-ask spread decomposition models and probability of informed trading estimates, we confirm the hypothesized relation between investor protection quality and adverse selection costs. These findings contribute to the literature by establishing one of the links in the chain connecting investor protection to firm valuation.

JEL Classifications D82 · G10

1 Introduction

The economic collapse of Soviet-block economies and the experiences of emerging markets during the 1990's have provided a unique opportunity to examine the salient features of market-based economies. One insight to emerge from these developments is that economic performance is significantly influenced by the national legal system. A market-supportive legal system promulgates and enforces the laws necessary to protect investor rights. Secure investor rights encourage the growth and development of financial markets, and sophisticated financial markets produce higher rates of economic growth. Although the chain of causation from the legal system to investor protection, financial

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