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Unintended consequences of securities regulation: Stock value loss upon potential involuntary delisting in Hong Kong

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ABSTRACT

This paper shows how stock prices in Hong Kong were crashed by an unexpected regulatory proposal to delist very low-priced stocks, with no discussion of other mechanisms for trading them. The results of this analysis, which are robust to various sensitivity tests, show that stocks trading below the proposed cutoff before the proposal were more likely to experience negative cumulative abnormal returns than other stocks, and that after the event firms were likely to undertake reverse stock splits to avoid future delisting, even though the document was withdrawn owing to public outcry. In general, this paper illustrates the importance of drafting and implementing regulation carefully to avoid unintended reaction by investors and minimize their economic losses.

1. Introduction

An advantage of listing stocks on a stock exchange is their increased liquidity, which raises the prices at which they can be traded; less liquid stocks have higher transaction costs as well as other costs of imperfect marketability, and investors discount the prices of those stocks (see Brennan & Subrahmanyam, 1996; Chordia, Roll, & Subrahmanyam, 2000). If stocks are delisted from a stock exchange, they become illiquid and can be sold only at lower prices, if at all. This paper uses a regulatory proposal in Hong Kong to illustrate how the potential loss of listing status and the attendant unexpected extreme illiquidity can trigger unintended investor behavior and crash the prices of stocks affected.

On July 25, 2002, Hong Kong Exchanges and Clearing Limited (HKEx) issued a consultative document on the stock market. Its intention was to improve the quality of the stock market by forcing firms with stocks trading at low prices to undertake a reverse stock split so that their stocks could be traded at higher prices.[1] Therefore, the consultative document solicited comments on, among other topics, whether stocks trading below, on average, HK$0.50 for more than 30 days should be delisted. However, the document did not discuss whether there would be other avenues, such as an over-the-counter market, that would enable investors of to-be-delisted stocks to recoup their investment, and investors were worried about the marketability of such stocks. Consequently, many low-priced stocks dropped in price substantially the next day owing to investor panic, even though the document was merely a proposal subject to finalization.

This study examines how investors' concern about the marketability of their stocks under threat of delisting affects stock prices.

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[1] According to the year 2002 HKEx Fact Book, there was no company that undertook a reverse stock split during July 12 to July 29, which covered the 3-day event window. Thus, the results reported in the paper are not likely to be affected by a reverse stock split, which is viewed as interrupting business operation without adding value (Li, 2002).

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The document was issued on a Thursday afternoon and withdrawn on the following Sunday (July 28, 2002) owing to public outcry, thus providing a unique short window which suggests that other events are not driving our results. Previous studies of the effects of stock market regulation have examined phenomena that are less fundamental and have an orderly effect on stock trading, e.g., tick size (Aitken & Comerton-Forde, 2005), price limit (Chen, Kim, & Rui, 2005), and closing mechanism (Aitken, Comerton-Forde, & Frino, 2005). This paper adds to the literature by showing that even a preliminary proposal can have a sudden and drastic effect on the stock market if it threatens to bring fundamental change. Although the results are obtained from the study of a single event, they provide useful insight that contributes to the literature (cf. Heflin & Wallace, 2017). Also, because regulatory effects depend on how well, or poorly, regulation is implemented and enforced (Djankov, Glaeser, La Porta, Lopez-de-Silanes, & Shleifer, 2003), this paper contributes to the literature on the unintended market effect of securities regulation by showing that poorly drafted regulation could drastically harm the stock market even at its proposal stage.

The setting studied here has some features that make it different from other settings. First, it is clearly evident in the consultative document that low-priced stocks were to be delisted: the threat to the liquidity of those stocks was not a rumor, and was likely to be drastic and have long-term effects. And since, unlike other stock markets, Hong Kong does not have an over-the-counter market to trade delisted stocks, proposed delisting was likely to elicit stronger market reaction in Hong Kong than in other jurisdictions.

Second, this potential delisting was forced by a proposed regulatory change, so the change in stock prices of the affected firms is expected to be unambiguously negative. In contrast, previous studies (e.g., Engel, Hayes, & Wang, 2007; Leuz, Triantis, & Wang, 2008; Macey, O'Hara, & Pompilio, 2008; Marosi & Massoud, 2007) have looked at voluntary delisting under an existing rule: firms could choose to withdraw from listing or not, depending on their own circumstances. Thus the stock price reactions were likely to incorporate the market's assessment of the firm's choice, and might not necessarily be negative, so that these studies may not provide very direct evidence of the value of listing that is lost upon delisting. In contrast, involuntary delisting is an exogenous event, and the market shock experienced by delisted firms is likely to reflect predominantly, if not solely, the economic loss of losing the listing status.

The next section of this paper provides the background of this study and develops the hypothesis. We then discuss the research method and describe the sample selection. The results section discusses the results of tests and additional analyses. In the last section we draw conclusions from the findings.

2. Background and hypothesis

2.1. The event

On Thursday July 25, 2002, HKEx issued a consultative document that proposed to delist firms from the main board of the Hong Kong Stock Exchange if their average stock price was below $0.50 for over 30 days, among other conditions (see Wong, 2002).[2] The purpose of the proposed change was to ensure that firms on the exchange were likely to be financially healthy and stable. This proposal followed criticism by a research report of the Securities and Futures Commission (SFC) and its former senior directors, claiming that poorly performing companies on the Stock Exchange had deterred international capital from flowing to Hong Kong and that low stock prices reflected the poor quality of listed companies (Seawright, 2002a). However, the new document did not discuss how investors could recoup their investment if firms were delisted. There was no mention of establishing an over-the-counter market for trading the stocks of delisted firms (Tran, 2002), or of any requirement that firms buy back stocks before being delisted. The reason given by an officer of HKEx was that these matters were under the jurisdiction of the SFC and outside the powers of HKEx ("HKEx's blunder", 2002).

The next day, the stock prices of more than 265 firms dropped drastically ("HKEx's blunder", 2002). Investors, worried that they could not recoup their investment if the proposals in the consultative document were adopted (Tran, 2002),[3] were "so panicked and so frightened that they … [sold] … their penny stock holdings at any price" immediately following the issuance of the document (Yiu, 2002a). Once the stock prices declined sufficiently, stock brokerage firms also sold stocks pledged to them as collateral (Ogden, 2002). Therefore, there was a crisis in a significant portion of the stock market on July 26, 2002.

Over the next few days, criticisms were raised against the proposals in the document. First, HKEx should not have used stock price and market capitalization as criteria for delisting, since they did not reflect firms' viability (Ogden & Yeung, 2002). Second, HKEx should have put forward plans for trading delisted stocks (Yiu, 2002a). Last, there should have been communication among HKEx, the SFC, and the government before the issuance of the document; if this had been done, the document would have discussed arrangements for protecting investors ("Penny stocks plan misguided", 2002). Officers-in-charge under fire included the chief executive of HKEx, Ki-chi Kwong, and the government secretary for financial services and the treasury, Frederick Ma. The latter probably provoked investors by claiming that, having taken office only on July 1, he had not had a chance to read the consultative document, which was buried in piles of files. As a result, the consultative document was withdrawn immediately, on Sunday July 28, 2002 (Yiu,

[2] Other conditions were (1) (a) a reported loss over three consecutive years and negative net worth in the current year, (b) a reported loss over three consecutive years and market capitalization below $50 million, or (c) market capitalization below $30 million; (2) adverse audit opinion or a disclaimer of audit opinion; (3) more than 75% decline in net assets, sales, or profit after taxation following sale of assets; (4) more than 90% of net assets in the form of cash, bonds, or stocks; (5) number of shareholders below 300, or below 1000 if market capitalization was over $4 billion; and (6) trading suspended continuously over 12 months. The results reported in this paper are robust to control for firms with a reported loss or unclean audit opinion and to the exclusion of those firms.

[3] It may be predictable that firms trading below $0.50 may face risk of delisting (see Seawright, 2002b), but the consultative document's lack of any discussion of an alternative trading mechanism for delisted stocks was not predictable, and it was this lack of alternatives that triggered the panic.