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# Journal of International Financial Markets, Institutions & Money

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## Effectiveness, cause and impact of price limit—Evidence from China's cross-listed stocks



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### ARTICLE INFO

#### Article history:

Received 18 March 2013

Received in revised form 13 October 2013

Accepted 16 December 2013

Available online 15 January 2014

#### JEL classification:

G14

G15

G18

G02

#### Keywords:

Price limit

Event study

News effect

China's cross-listed stocks

### ABSTRACT

This paper examines the effectiveness, cause and impact of price limits by comparing cross-listed Chinese stocks in China (A shares), Hong Kong (H shares) and New York (N shares). Price limit is found to have some effectiveness in preventing price continuation, but is ineffective in that the findings confirm volatility spillover and trading interference hypotheses from Kim and Rhee (1997). International news and corporate level news are both found to have significant impact on the abnormal returns of the A shares during or after the price limit hits, especially for upper limit hits.

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We would like to thank participants at the 2012 Financial Management Association annual conference in Atlanta, GA, and 2012 Southern Finance Association annual conference in Charleston, SC; especially our discussant Jimmy Yang, for valuable suggestions. We would also like to thank an anonymous referee for his/her insightful comments. Thanks also go to Mengqi Zhao, Tongzhou Zhang, Jing Chen, Yanli Wei, Qi Cao, Minghui Zhang, Yiyue Ren and Ninad Chaudhary for their excellent assistance in data collection and proofreading.

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## 1. Introduction

Daily price limit is often used in emerging stock markets to prevent stock prices from rising or falling too fast or too much. It usually sets a price range, within which daily prices can fluctuate, based on a certain percentage of previous day's closing prices or other specified prices. In June 2012, the SEC approved a similar proposal put forward by national stock exchanges and Financial Industry Regulatory Authority (FINRA) after the "Flash Crash" on May 6, 2010 to introduce the "limit up-limit down" mechanism to curb excessive volatility in individual securities and overall stock market index.<sup>1</sup> The purpose of using price limit mechanism is to serve as a circuit breaker. When new information arrives, irrational investors cannot digest information quickly enough and tend to herd after others, which will cause stock prices to overshoot. Advocates of price limit argue that price limit can moderate stock price volatility and correct overreaction in the market as investors reevaluate new information during the cooling-off period. Usually you will see price reversals, lower volatility, or thinner trading volume after price limit hits. On the other hand, critics argue that price limit mechanism cannot effectively stop the order flow after the limit hits and find evidence that price limit only delays price discovery process, causes volatility spillover, and affects liquidity of stocks in the days following price limit hits.

This paper examines China's price limit mechanism from a unique perspective, using cross-listed stocks on the Shanghai/Shenzhen Stock Exchange in China (A-share) and the Hong Kong Stock Exchange (H-share). We also include the New York Stock Exchange (N-share) in our study for comparison purpose although most results are reported using A shares and H shares due to space limitation.<sup>2</sup> Cross-listed stocks are shares from the same company but listed on different stock exchanges. They have the same fundamentals such as cash flows, earnings, etc., from the company. These cross-listed stocks are also from large companies that typically have less information asymmetry compared to smaller companies. Therefore, if markets are efficient, when information is released from one market, it will quickly spread to other markets and prices in these markets will respond accordingly. However, this does not always happen for Chinese cross-listed stocks. One big difference between these markets is the price limit imposed. In China's A share markets, all stocks are subject to 10% daily price limit since 1996, which means stock prices cannot increase or decrease more than 10% of previous day's closing price. Once the limit is hit, only transactions at the upper limit or lower limit will be executed. On the other hand, N share and H share markets do not have any price limits. This poses an interesting situation where we can compare the performance of the same company's stocks listed on different stock exchanges. No prior research has used cross-listed stocks to study price limit mechanism.

The literature on cross-listed stocks has either focused on whether the Law of One Price holds for cross-listed stocks (see [Kato et al., 1990](#); [Park and Tavokkol, 1994](#), etc.) or tried to explain why returns are different for cross-listed stocks in different markets, after controlling for factors such as exchange rates, time-zone difference, regulations, locations, etc. (see [Werner and Kleidon, 1996](#); [Grammig et al., 2005](#); [Gagnon and Karolyi, 2010](#)). For China's cross-listed stocks, the focus was on price premium of A shares over B shares<sup>3</sup> in early studies (see [Chakravarty et al., 1998](#); [Chen et al., 2000](#)). Only recently researchers have examined the directions of information flow and volatility spillover of A share and H share or A share and N share (see [Chen et al., 2010](#); [Chelley-Steeley and Steeley, 2012](#)). The general findings that A shares are more affected by local information while H shares and N shares are affected both by information from A shares and information from global markets help explain the direction

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<sup>1</sup> On May 6, 2010, Dow Jones Industrial Average fell more than 600 points in 5 min, for an almost 1000-point loss on the day, only to recover most of the drop 20 min later. The limit up-limit down mechanism will be effective in February 2013 as a one-year pilot program. It sets a price band of a certain percentage above or below the average price of the security in the previous 5-min period. If the price goes outside of the band, then trading can only occur within the band; if no trading occurs within 15 s, there will be a 5-min trading pause.

<sup>2</sup> Results for A shares and N shares cross-listed stocks are similar with those of A shares and H shares and are available upon request.

<sup>3</sup> B shares are listed on China's stock exchanges, available only to foreign investors before 2001 and denominated in U.S. dollars, but opened up to domestic investors since 2001.

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