Pacific-Basin Finance Journal 26 (2014) 98–122

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Short-sales constraints and liquidity change: Cross-sectional evidence from the Hong Kong Market

Min Bai [a,*], Yafeng Qin [b,**]

[a] *Finance Department, Auckland University of Technology, Private Bag 92006, Auckland 1142, New Zealand*
[b] *School of Economics and Finance (Albany), Massey University, Private Bag 102 904, North Shore Mail Centre, Auckland 0745, New Zealand*

ARTICLE INFO

Article history:
Received 5 July 2013
Accepted 15 November 2013
Available online 23 November 2013

JEL classification:
G12
G14
G18

Keywords:
Short-sales constraints
Liquidity
Stock valuation
Investor opinions dispersion

ABSTRACT

This study investigates the impact of short-sales constraints on liquidity for individual stocks in Hong Kong, as the Hong Kong Stock Market has a special feature such that, at each point of time, only a subset of stocks are allowed to be sold short, with the list of these stocks changing over time. We find that the impact is heterogeneous across stocks: Following the repealing of short-sales constraints, only large, illiquid and inactively traded firms increase in liquidity; while others significantly drop in prices and liquidity. Following the imposing of short-sales constraints, only inactively traded stocks significantly increase in liquidity and prices. The heterogeneous liquidity change also affects the relation between stock overvaluation and one of its necessary conditions — dispersion of investor opinions. When stocks are allowed to be sold short, such a relation is stronger for firms with deteriorating liquidity. When stocks are prohibited from being sold short, this relation disappears among firms with deteriorating liquidity.

© 2013 Elsevier B.V. All rights reserved.

1. Introduction

Many stock market regulators around the world blame short selling for destabilizing the markets and causing price drops unrelated to fundamentals. Hence, they impose bans, or various constraints, on short sales, aiming to restore a more functioning market and prevent sudden and significant declines in prices, especially during a financial crisis. For example, Beber and Pagano (2013) show that during the 2008–2009

* Tel.: +64 9 921 9999x8805; fax: +64 9 9219940.
** Tel.: +64 9 414 0800x43178; fax: +64 9 441 8177.
E-mail addresses: min.bai@aut.ac.nz (M. Bai), y.qin@massey.ac.nz (Y. Qin)

0927-538X/$ – see front matter © 2013 Elsevier B.V. All rights reserved.
http://dx.doi.org/10.1016/j.pacfin.2013.11.004

crisis, among the 30 sample countries in their study, 21 imposed bans on short-selling practises, either on all the stocks, or on stocks from some specific sectors such as the financial industry.

There has, however, been debate over the effectiveness of such regulations. Most of the criticism comes from the argument that short-sales restrictions could reduce market liquidity and hinder price discovery. The first concern could be especially detrimental during crises, when market participants are in greater need of liquidity. This study offers a direct examination of how short-sales restrictions affect the liquidity of individual stocks. In particular, we compare the liquidity of the same stocks before versus after the short-sales restrictions change, and investigate the role of the effect of this change in the price discovery process. The Hong Kong Stock Exchange provides us with an ideal setting to conduct such research, where only stocks that meet certain requirements are allowed to be sold short. The list of designated stocks that can be sold short is revised on at least a quarterly basis, and stocks that become newly eligible will be added to the list, while stocks that are no longer eligible will be removed from it. This practise enables us to trace the changes in liquidity of individual stocks after any changes in the short-sales regulations.

Short-sales constraints affect liquidity in several ways. First, short-sales constraints will change the ownership structure of the securities and, thus, change the liquidity. Diamond and Verrecchia (1987) point out that short sellers are more likely to be informed investors and short-sales constraints prevent informed investors from trading on bad news. One implication of their model is that short-sales constraints will decrease the proportion of informed investors. The proportion of informed investors could affect the liquidity of the securities for two reasons: 1) Informed investors would never initiate a short sale for liquidity reasons (Boehmer et al., 2009). In aggregation, short sellers appear to trade on fundamentals and they earn excess returns (Dechow et al., 2001; Desai et al., 2006; Cohen et al., 2007; Boehmer et al., 2008). Therefore, these short sellers are more likely to demand rather than supply liquidity in the market and their reduced trading will increase the overall liquidity of the underlying securities. Meanwhile, a lower proportion of informed traders means a higher proportion of uninformed traders, who are more likely to be individual investors and liquidity suppliers, especially in the order-driven markets where there are no dealers obliged to provide liquidity. When the proportion of uninformed traders increases, liquidity also increases; and 2) The presence of a low proportion of informed traders will decrease the adverse selection component of the bid–ask spread, thus, decreasing the overall transaction cost and enhancing liquidity (Amihud and Mendelson, 1986; Easley and O'Hara, 2004; Hughes et al., 2007). On the other hand, however, a low proportion of informed trading will also impede the speed of price discovery, resulting in a delayed resolution of uncertainty about fundamentals, and thus increase the bid–ask spread and decrease liquidity (Diamond and Verrecchia, 1987; Wang, 1993). Therefore, short-sales constraints and the resulting decrease in informed trading could either increase, or decrease, the liquidity of securities, or have both effects at the same time resulting in an insignificant impact.

Second, the changes in short-sales restrictions could affect liquidity due to an attention effect. The Hong Kong Stock Exchange revises the designated list of securities that are eligible for short selling on a quarterly basis, and the securities to be added to the list have to meet certain criteria. Once the securities can no longer meet these criteria, they are removed from the list. Among the eleven criteria[1], liquidity, market capitalization and whether the stock is a constituent stock of major indices are the dominant factors. Once the Hong Kong Stock Exchange decides to include a stock in, or remove a stock from, the list, it increases the attention paid to the stock by the investment community. On the one hand, increased attention from media and financial analysts enhances and expands the information on those stocks accessible in the market, which increases the liquidity of the stocks by reducing investors' information acquisition costs and the adverse selection component of bid–ask spreads. On the other hand, increased attention from investors will increase the trading volume and, thus, increase liquidity. Such an effect, however, might not be homogeneous across all stocks. Stocks that have relatively low visibility before the change in their short-sales regulation should benefit more from such an attention effect than stocks that already had high visibility before the change.

Therefore, the effect of short-sales constraints on stock liquidity in the Hong Kong Stock Market is ambiguous. We posit that the impact of short-sales restrictions on liquidity is partially unpredictable and heterogeneous across stocks. Specifically, the impact on liquidity depends on factors such as the market's perception of information asymmetry, as well as the visibility of the firms. This study tries to investigate these issues. In particular, we take advantage of the special feature of the Hong Kong Stock Market and

[1] As of June 2010, the Hong Kong Stock Exchange updated the criteria that determine a stock's eligibility to be sold short. The details of the regulation on the selection of stocks to be added to the list are provided in Appendix A.

Download English Version:

https://daneshyari.com/en/article/973709

Download Persian Version:

https://daneshyari.com/article/973709

Daneshyari.com