



## Chinese block transactions and the market reaction

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### ABSTRACT

This paper examines block transactions in the Chinese equity market. We find that most of the block transactions are traded at prices at or below the closing price of the regular continuous auction market, and more than half are traded at or below the lowest price of the day. Consistent with the price pattern indicating that the block transactions are seller-initiated, the overall market reaction is negative. However, we find a different market reaction to block transactions when the buyer is represented by China International Capital Corporation (CICC), the number one investment bank in China which counts many foreign institutional investors as its clients. The positive reaction is consistent with the buyer-certification hypothesis, that is, the fact that some smart institutional buyers enter block trade indicates the buyers' assessment of undervaluation.

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## 1. Introduction

Trading is at the heart of financial markets and an important topic in financial economics. Block trading, the trading of a large number of securities, has also attracted much attention because of the large size of the block and its great impact on the market.<sup>1</sup> In this paper we study block trading in China. Two features make Chinese block transactions unique and interesting. First, block transactions in China do not have dealers or market makers to act as the middle man. Block transactions in China are typically negotiated between the seller and the buyer directly and later reported to the exchanges for documentation. Without dealers as the middle men in block transactions, the typical benefit of block trading such as accessing hidden liquidity (Grossman, 1992), certification of liquidity trades by the upstairs dealer (Seppi, 1990), does not apply in China. Second, every day after the market close and after additional 30 minutes for block transaction reporting, the two Chinese exchanges, Shanghai Stock Exchange and Shenzhen Stock Exchange, publish all the block transactions on their websites. From these websites, investors can find the stock, the transaction price, volume, and the branch offices of the buyer and seller's brokerage firms. Although the identity of the buyer and seller is not disclosed, investors may infer the identity or at least the category of the buyer and/or seller from the branch office information.

Given the lack of middle man in Chinese block transactions and the fact that only institutional investors are allowed for block transactions, it is not clear what information content block trades convey. On one hand, the sellers of block transactions are large shareholders of the company and they have better information about the company than everyone else in the market. The fact that they are selling their shares through block trade may imply that they know some negative information in advance and they are trying

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<sup>1</sup> For early seminal works on trading, see Glosten and Milgrom (1985) and Kyle (1985). For theoretical works on block trading, see Seppi (1990), Grossman (1992), and Foster, Gervais, and Ramaswamy (2007). For empirical works on block trading, see Bessembinder and Venkataraman (2004), Keim and Madhavan (1996), Madhavan and Cheng (1997), etc.

to dump their shares at whatever price, or the sellers intend to reduce their holdings of the stock and there may be more selling in the future. Either way, there is a downward price pressure on the stock. We call this effect the seller-reducing-holdings hypothesis. On the other hand, the buyers of block transactions are not noise traders. They are institutional investors and they should be able to take into consideration the sellers' motive to dump shares ahead of negative news. The fact that these sophisticated institutional buyers are willing to buy the stock implies that these buyers consider the stock undervalued. In this case, the block transaction can be an endorsement by the buyers and hence send a good signal to the market. We call this effect the buyer-certification hypothesis.

To differentiate the two hypotheses is an empirical matter. The reporting and publication of block transactions make this a clear-cut study. Given that block transactions are disseminated to the public in a timely fashion on the exchanges' website and routinely reported in Chinese business news outlets, we can study the market reaction to these block transactions to see which hypothesis dominates. If the market reaction is generally negative, then the seller-reducing-holdings effect dominates. If the market reaction is overall positive, then the buyer-certification effect holds more weight.

We find that most of the block transactions are traded at prices at or below the closing price of the regular continuous auction market, and more than half are traded at or below the lowest price of the day. This result is consistent with what Huang and Xu (2009) find in an early sample of Chinese block transactions. However, this result is opposite to what most works on block trade in U.S. and other countries, where large blocks are usually priced at a premium, and especially if the block trade is connected to corporate control change (See Barclay and Holderness (1989) and Dyck and Zingales (2004) etc. For a survey on block trade and corporate control, see Holderness (2003)).

Given the prevalent discount of block transactions in China, it appears that most block transactions are initiated by the sellers. The price discount of block transactions is smaller when the firm is large, indicating that large firms have smaller information asymmetry and thus command smaller discount. Meanwhile, the overall market reaction is negative toward block transactions. This implies that investors treat block transactions as bad news in general, consistent with the sell-reduce-holdings hypothesis.

However, we also find some interesting results when the broker representing the buyer is China International Capital Corporation (CICC). CICC is the number one investment bank in China and its Hua Hai Zhong Road Branch in Shanghai represents many foreign institutional investors.<sup>2</sup> It is widely recognized in China that these foreign institutional investors are the most sophisticated investors. Thus their purchase can send a positive signal to the market. While the identity of the buyer in block transactions is not revealed, the market may infer the identity or at least the type of the buyer by the representing brokerage. We find that the block discount is smaller and the market reaction is positive when the buyer is represented by CICC. This positive reaction to CICC represented deals provides evidence in support of the buyer-certification hypothesis.

Our research contributes to the literature on block trading in two fronts. On the one hand, we provide the first systematic study on the market reaction to Chinese block trading. Huang and Xu (2009) study an early sample of Chinese block transactions and their focus is on the pricing of these block transactions and the connection to corporate control. In this paper, we extend their study to a recent time period and also a period when block transactions become much more popular due to the policy change. We also focus on the market reactions to block transactions and find some interesting results.

On the other hand, our paper complements the block trade literature by studying a trading environment where the buyer and the seller negotiate directly. We document a scenario that the buyers are able to extract large concession from the sellers by setting low purchase prices, and the market reacts negatively to such transactions. However, there is some evidence that the market recognizes one large investment bank as the smart buyer and reacts positively to the appearance of this buyer. There is some anecdotal evidence of such buyer-certification effect in the U.S. market. For example, the market reacts positively to Warren Buffet's investment in Goldman Sachs and other companies, although Buffet gets much preferable terms than ordinary investors. The Chinese block trading environment provides an ideal setting for testing this effect.

This paper is organized as follows: Section 2 describes the Chinese block trading environment. Section 3 presents the data and Section 4 discusses the results. Section 5 concludes the paper.

## 2. Block trading in China

There are two security exchanges in China, Shanghai Stock Exchange and Shenzhen Stock Exchange. The main trading mechanism on both exchanges is the order-driven continuous auction. For a long time, there was no separate method to transact large quantity of securities. On February 25, 2002, the first block trade appeared on Shenzhen Stock Exchange. This transaction marked the beginning of block trade on Chinese security exchanges. In January, 2003, Shanghai Stock Exchange published the rules that govern block transactions and later established the electronic platform for block transactions. Since then, block trades appeared on both exchanges.

The minimum threshold for block trading is 500,000 shares or 3,000,000 yuan (1 U.S. dollar is equal to somewhere from 6.5 yuan to 8.5 yuan from 2003 to 2008). Unlike the continuous auction where buyers and sellers trade against the limit order book anonymously, block trading in China is typically negotiated directly between the buyer and the seller outside the exchanges. Both the buyer and the seller are required to be qualified investors, i.e., member firms of the exchanges or large institutional investors. After an agreement is reached, the two parties inform the exchanges' block trading platform that a block transaction has completed.<sup>3</sup> The exchanges then

<sup>2</sup> Many Chinese news outlets and financial websites have reported that the clients of the Hua Hai Zhong Road Branch of CICC are foreign institutional investors. For an example, see <http://zldx2.stock.cnfol.com/090313/149,1475,5582859,00.shtml>.

<sup>3</sup> Technically, the potential buyer (seller) can register his or her intention to buy (sell) a certain quantity of stocks at a price and the exchanges would publish this intention to the public without disclosing the identity of the buyer (seller). This is called registration of intention. Since the direction of trading is disclosed, this form of registration is almost never used. Since 2003, there is only one such incidence.

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