Summary

Short sale is a transaction of selling financial assets that an investor does not own currently by borrowing them with the intention that one can subsequently repurchase them at lower prices and therefore enjoy the capital gain, typically for a very short period of time. Given the prevalence of short-sale bans on financial markets around the world and the inconclusive results of their impacts both in theoretical and empirical literature as a background, this dissertation attempts to empirically examine the impact of short-selling in financial markets and to enhance the understanding on this subject among regulators, investors and academics. In this study, a negative relationship between the heterogeneity of investors' beliefs and future returns under short sale ban is confirmed in Shanghai Security Exchange, where short-sale ban is imposed for decades. This relationship is robust with controlling for several stock characteristics such as size, leverage, book-to-market ratio, momentum, and different quantiles of the distribution of returns. Although a similar negative relationship between the heterogeneous beliefs and future returns is found for the stocks under short-sale ban in Hong Kong Stock Exchange, this relationship disappears if short-sale ban is lifted. Moreover, such a varying impact of short-sale ban on future returns is stronger if good news of companies' earnings are announced, because the ban tends to eliminate potential short-sellers, who have relatively negative opinions on companies' earnings. Therefore, relatively optimistic investors remain in the market and their opinions are easily augmented by good earnings news, which makes them to purchase more aggressively, leading to greater overvaluation of stock prices. In addition to the impacts on future returns, this study establishes that the short sale ban has a positive effect on liquidity during a non-crisis period, while such an effect disappears during the 2007-2009 financial crisis period. These findings suggest three important policy

implications. First, the effect of short-sale ban on future returns is typically negative. Second, short-sale constraint of a Hong Kong-style may support liquidity of somewhat distressed stocks during a normal period, so that the effect of a short-sale ban on stocks may be subject to a trade-off between a negative impact on future returns and a positive impact on current liquidity. Third, the liquidity-supporting effect of a short-sale constraint may disappear in the face of a market-wide financial distress.