

Research on Market Contagion of Share Pledge: Risk and Investor Protection under Registration System Reform

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Abstract. Under the registration system reform, China's capital market faces new opportunities and challenges. The market contagion of listed companies' share pledge risk is increasingly prominent. It threatens investors' interests. This study explores the market contagion mechanism and investor protection strategies of share pledge risk under the registration system reform through qualitative research. Gree Electric and Wanfeng Aowei are used as cases. The study finds that share pledge risk has high leverage, information asymmetry, and strong market contagion. Its contagion mechanism is mainly reflected in stock price fluctuation transmission. It also involves industry-related contagion, capital chain contagion, and investor sentiment contagion. Risk diffusion is caused by insufficient information disclosure. Based on the findings, the study proposes investor protection strategies. These include improving information disclosure systems, strengthening market regulation, optimizing investor education, and perfecting laws and regulations. This study aims to provide theoretical and practical guidance for preventing market contagion of share pledge risk. It also aims to protect investors' interests and promote stable and healthy capital market development.

1 Introduction

The reform of the registration system is pivotal for the advancement of China's capital markets. This reform emphasizes enhancing information disclosure, optimizing resource allocation, and improving overall market efficiency. However, as the reform is fully implemented, the number of listed companies continues to grow, making the market increasingly complex. Alongside this growth, the risk associated with share pledges is becoming more prominent. While share pledges offer financial support to listed companies, they also introduce contagion risks that can adversely affect investor interests. Thus, understanding the market contagion mechanisms of share pledge risks and developing effective investor protection strategies within the context of the registration system reform is both theoretically and practically significant [1].

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This study aims to explore how share pledge risk spreads in the market under the registration system reform and to identify effective strategies for protecting investors. The research questions focus on understanding the contagion mechanisms of share pledge risk and developing actionable strategies to safeguard investors' interests. The primary objectives are twofold: first, to analyze the pathways through which share pledge risk propagates in the market, and second, to propose practical measures that can mitigate such risks and protect investors. The contributions and importance of this study lie in its ability to provide valuable insights into the market behavior of share pledge risk, which can inform the formulation of policies aimed at safeguarding investors' interests. By shedding light on these mechanisms, the research not only advances theoretical understanding but also contributes to the stability and healthy development of the capital market, ensuring that investors are better protected in an evolving regulatory environment [2].

2 Literature review

2.1 Research background

The existing research on share pledge risk mainly focuses on three aspects. One aspect is the motives and influencing factors of share pledges. These include financing needs and control rights consolidation. Another aspect is the risk transmission mechanisms. These include stock price fluctuations and capital chain breaks. The third aspect is investor protection studies. These focus on information disclosure and legal frameworks. However, most prior studies have been conducted within the context of the traditional approval-based systems. There is a noticeable gap in research regarding the contagion mechanisms of share pledge risks and the strategies for investor protection in the context of the registration system reform. Such research is limited in both depth and systematic approach. To address this gap, the current study builds upon existing literature and incorporates the unique characteristics and requirements introduced by the registration system reform. It aims to provide a more comprehensive exploration of the market contagion mechanisms and investor protection strategies related to share pledge risk in this new regulatory environment [3].

2.2 Theories and framework

Information asymmetry is a critical factor in the contagion of share pledge risk. When major shareholders pledge their shares, the disclosure of pledge-related information is often incomplete or delayed. This creates an information gap between insiders and external investors. Asymmetric information can lead to adverse selection and moral hazard. It can also amplify market contagion. For example, if investors perceive that a company's pledge ratio is too high, they may lose confidence in the company's financial stability. This can trigger sell-offs that spread to related companies or industries [3].

Behavioral finance highlights the importance of investor sentiment and irrational decision-making in the spread of market contagion. When share pledge risks become public, investors tend to overreact to negative news, leading to panic selling. This emotional contagion can extend beyond companies directly affected by the risk, influencing even unrelated companies. Research indicates that investor sentiment significantly contributes to the amplification of financial risk contagion, particularly in volatile markets [4].

Share pledge risk can escalate into systemic risk, initiating a chain reaction across the financial system. The high leverage and interconnectedness of financial institutions increase the vulnerability to cascading failures. For instance, a major shareholder's pledged shares may be liquidated due to a margin call, causing a decline in stock prices. This can negatively

affect lenders, other investors, and potentially the broader economy. Several models have been proposed to analyze risk contagion in financial markets. The network model views the financial system as a network of interconnected nodes. Each node represents a company or institution. Risks propagate through links such as shared creditors, industry peers, or supply chain relationships. The contagion threshold model identifies critical thresholds beyond which risks spread uncontrollably. These models provide a structured approach to understanding how share pledge risk spreads. They also show how regulatory policies can mitigate its impact [5].

2.3 Research gaps and future direction

Despite the valuable contributions of existing studies, several gaps remain. Most research focuses on individual companies or industries. It neglects the systemic implications of share pledge risk. Limited attention has been paid to the interaction between share pledge risk and market structure under the registration system reform. Few studies incorporate behavioral finance or network theory to analyze contagion mechanisms. Future research could address these gaps by developing integrated models. These models could combine systemic risk, behavioral finance, and network theory. Researchers could examine the role of regulatory policies in mitigating contagion under different market conditions. They could conduct empirical analyses using large-scale datasets to validate theoretical predictions [6].

3 Current situation and characteristics of share pledge risk

In recent years, the scale of share pledges among A-share listed companies has expanded, with an increasing number of companies exhibiting high pledge ratios. By the end of 2021, 4,697 A-share listed companies were registered, with 2,517 of them having equity pledges. The total pledged market value amounted to 4.18 trillion yuan, covering 19,600 pledge transactions. In some cases, major shareholders' pledge ratios approach or even exceed 100%, exposing companies to significant liquidity and control-shift risks. A sharp decline in stock prices could trigger margin calls, leading to forced liquidation and further stock price drops, potentially culminating in systemic risks. Share pledge risk is characterized by high leverage, which facilitates low-cost funding but also amplifies stock price volatility. It involves information asymmetry, owing to insufficient disclosure, and exhibits strong market contagion, spreading risks through market sentiment and capital flows [7].

4 Market contagion mechanism of share pledge risk

The market contagion of share pledge risk first shows in stock price fluctuation transmission. When major shareholders' pledged shares hit margin - call lines, pledgees may sell shares to compensate for losses. This causes further stock price drops. It creates a vicious cycle of risk exposure. For example, as of November 23, 2024, Wanfeng Aowei had 228 million shares pledged. The value was 45.25 billion yuan. The pledge ratio of its controller and consistent action persons was 27.19%. A significant stock price drop near the margin - call line could trigger liquidity risks. It could impact market confidence. In the same industry or upstream - downstream companies, the contagion is more evident. Similar market and operational risks within an industry can lead to widespread sector - wide stock price declines. When one company's pledge risk is exposed, it affects the entire industry. Additionally, when funds from share pledges are used for other projects or companies, investment failures may cause capital chain breaks. This affects the pledging company's stock price. It causes liquidity crises in related enterprises. Investor sentiment also plays a role in the contagion mechanism.

Individual company's pledge risk exposure may spread panic. This leads to irrational selling. It causes broader risk dissemination. Moreover, insufficient disclosure of pledge-related information exacerbates market contagion. Investors struggle to assess companies' risk conditions accurately upon discovering inadequate information disclosure. This may trigger market distrust. It may lead to sell-offs [8].

5 Challenges in investor protection

Currently, the disclosure of share pledge information is neither timely nor complete, hindering investors' ability to assess risks effectively. With the increasing number of listed companies and growing market complexity under the registration system, regulatory oversight becomes more challenging. The mechanisms of market contagion are intricate, and single regulatory measures are insufficient to prevent risk escalation. Furthermore, many small and medium-sized investors lack the professional knowledge and risk identification skills necessary to protect themselves from share pledge risks, leaving them more susceptible to financial losses. Existing investor protection mechanisms fail to adequately address the risks associated with market contagion [9].

6 Investor protection strategy recommendations

To address these challenges, several strategies are proposed. First, enhance the timeliness, accuracy, and completeness of share pledge information disclosure by listed companies. Mandate prompt disclosure of key details like pledge ratios, purposes, and margin - call lines after pledging actions. Increase penalties for non - compliance. Second, strengthen market regulation. Enhance monitoring and analysis of the share pledge market. Establish risk - warning mechanisms for early detection and disposal of potential risks. Impose stricter supervision of pledge fund usage to prevent misuse. Third, optimize investor education. Intensify efforts to improve small and medium investors' risk - identification and decision-making capabilities through diverse channels. Popularize share pledge risk knowledge. Promote rational investment. Lastly, refine securities laws. Clarify legal responsibilities related to share pledge risks. Bolster investor rights protection. Establish effective civil compensation mechanisms. Enhance investors' rights - protection efficiency [10].

7 Conclusion

The market contagion of share pledge risk has intensified in the context of the registration system reform, highlighting the need for improved investor protection. By enhancing information disclosure, strengthening market regulation, optimizing investor education, and refining legal frameworks, the spread of share pledge risk can be effectively controlled, safeguarding investor interests and promoting the stable and healthy development of the capital market. This study, through qualitative analysis and case studies, reveals the market contagion mechanisms and investor protection strategies of share pledge risk. It offers valuable insights for related research and practice. However, due to time and data constraints, this study has some limitations. For example, the in-depth quantitative analysis of market contagion mechanisms is insufficient. Future research can expand data sources. It can employ more advanced methods to conduct more in-depth quantitative analyses of the market contagion mechanisms of share pledge risk. This can enhance the scientific and accuracy of the research.

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