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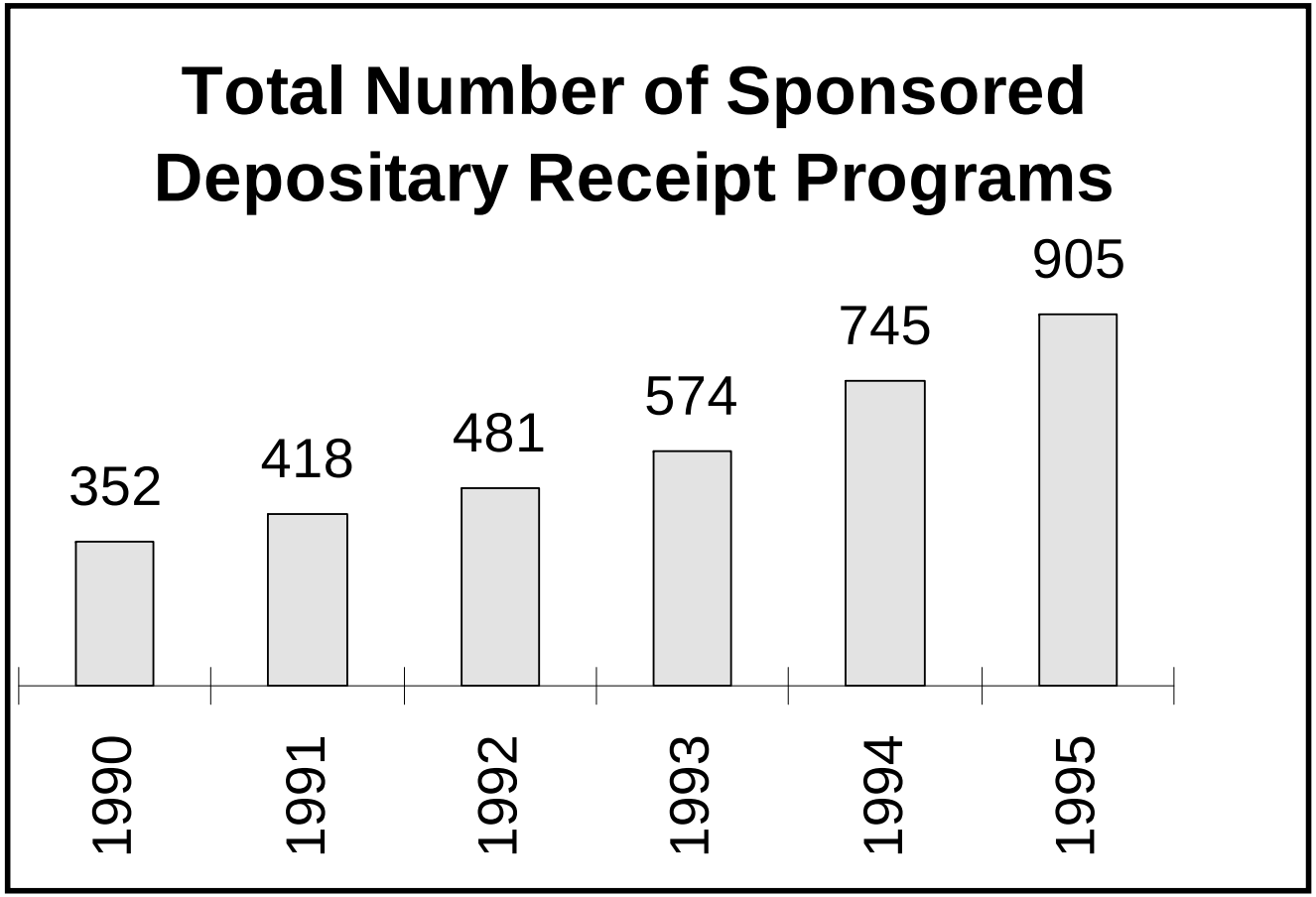
A Critique of Cross-border Listings Research and Some New Evidence from Alternative Methods

2008 CARE Conference

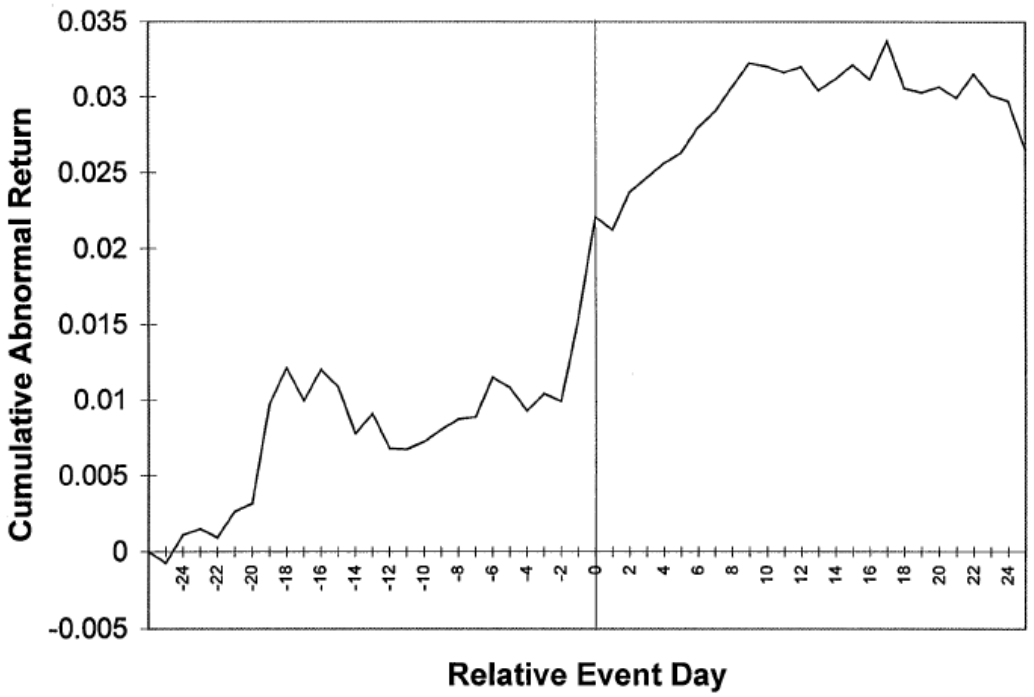
The Past: Cross-Border Listings in the U.S.



The Past: Cross-Border Listings in the U.S.

- Why do foreign firms list in the U.S.? Miller (1995)

D.P. Miller / Journal of Financial Economics 51 (1999) 103–123



Cross-Border Listings: Present

- The last decade as seen large literature develop that measures the economic outcomes of international cross-listings.
- Today, cross-border listings are under intense scrutiny by academics and policy makers because of their governance costs and benefits.
- There are two main questions that are being intensely debated

Cross-Border Listings: Present

1. Can firms "opt-in" to better legal systems by cross-listing in a stronger investor protection country?
   -formalized as the "Bonding Hypothesis" of Coffee (1999)
   -most often motivated and analyzed using cross-listings in the U.S.

2. Do the costs of securities regulation outweigh the benefits
   -Lots of recent attention in the U.S. and London

The answers to both of these questions are very much in debate. But why? Let's look at each one in turn.

The Bonding hypothesis

- When a firm cross-lists on a major U.S. exchange, it becomes subject to U.S. investor protection laws, disclosure obligations and enforcement, which commits the listing firm to respect minority investor rights and thereby improves corporate governance.

- The “functional convergence” of global legal systems..

What The Theory Predicts

- Cross-listed firms will have better corporate governance than non-cross-listed firms from the same country
- The effect of bonding will be greatest for firms adopting the strongest investor protections, e.g., those that list on a major U.S. exchange.
- The difference in governance between CL and non-CL firms will be greatest in countries with the weakest investor protections.
- Theory does not predict specific *economic* outcomes.

Q1.Does Bonding Hold?

- Those in favor cite the fact that cross-listed firms from weak investor protection countries have:
- Positive stock price reactions around listing
  - Miller 1999, Foerster and Karolyi 1999
- Higher valuations
  - Doidge, Karolyi, Stulz (2004,2008), Mitton 2002
- More scrutiny by financial analysts
  - Baker,Nofsinger, & Weaver (2002); Lang, Lins,& Miller (2003,2004), Crawford (2007)
- Better Information Environments

  -Amir, Harris & Venuti (1993), Bailey, Karolyi, & Salva (2005); Lang, Raedy, Yetman (2003), Hope et al. (2006)

The Debate: Does Bonding Hold?

- Lower Cost of Capital
  - Errunza and Miller (2000), Hail and Leuz (2005)
- Better access to external finance
  - Reese and Weisbach (2002), Lins, Strickland and Zenner (2005)
- Lower voting premiums (Doidge 2004)

Some problems with these studies

- The vast majority of research into the impact of cross-listing has focused on the economic outcomes
  - Stock Market Reaction to self-selected (de) listing "events"
  - Valuation (Tobin's Q) effects of listing
  - Cost of Capital changes around listing
  - Ownership Structure differences
- While much has been learned, much of this economic outcomes research is inherently limited by joint hypothesis problems and endogenity concerns.
- Perfect Example: Miller 1999

Miller (1999)

DR type (N)	$t = -25$ to -2	$t = -1$ to $+1$	$t = +2$ to $+25$
Panel A: Exchange			
PORTAL(40)	0.0257	− 0.0109	− 0.0419
OTC pink sheets (88)	0.0032	0.0127**	0.0265*
NYSE/NASDAQ(53)	0.0099	0.0263**	0.0118
Panel B: Geographic location			
Developed (107)	− 0.0002	0.0087**	0.0022
Emerging (74)	0.0251	0.0154*	0.0141
Panel C: IFC Classification			
Developed (107)	− 0.0002	0.0087**	0.0022
Free emerging (26)	0.0017	0.0269*	0.0277
Restricted emerging (48)	0.0377	0.0092	0.0067
Panel D: Equity offering type			
Public (30)	0.0171	0.0323**	0.0106
Private placement (40)	0.0257	− 0.0109	− 0.0419
No capital raised (111)	0.0027	0.0139**	0.0238*
Full sample (181)	0.0101	0.0115**	0.0071

Economic Impact Ambiguity

- Why does the market react? Why are firms worth more? Why does the cost of capital decrease? Why does disclosure/analyst following increase? Why is capital access better?
  - Bonding (i.e. governance)? Market Segmentation? Liquidity? Signaling? Investor Recognition
  - Almost all theories of cross-listing predict economic outcomes in the same direction, making distinguishing between them incredibly difficult.
- However, evidence against bonding is also problematic

The Debate on Bonding: The other side

- Siegel (2005)
  - Documents that US law enforcement neither deterred nor punished a group of Mexican insiders who illegally stole over 1billion from their firms during the Mexico crises (many with ADRs)
- Licht (2003): SEC applies a lower standard of enforcement for corporate governance rules
- Lang, Raedy, Wilson (2006): CL firms have lower quality accounting data than U.S. firms
- Bradshaw and Miller (2008): Foreign firms adopting GAAP don't always adopt it as they should.
- However, the evidence in many of these studies also may be subject to different interpretations.
  - Leuz (2006), Benos and Weisbach (2004)

Another difficulty in testing

- A good governance mechanism (e.g., disperse ownership) does not necessarily mean good performance of a corporate governance "system", as mechanisms often can be substitutes or complements (Doidge et al 2005, LLSV 1998).
- In a cross-listed firm, this is likely to be exacerbated given the many changes that take place.
  - Lang, Lins Miller (2003,2004)
- Therefore, changes in mechanisms (e.g, ownership concentration, analyst following, Boards) around cross-listing not likely to be unambiguous evidence about governance.

A “New” Approach to Test the Bonding Hypothesis: Governance Outcomes

- Lel and Miller (2007), forthcoming *Journal of Finance*

- We argue that if CL bonds firms to increased shareholder protections, we should be able to observe actual outcomes that are consistent with improved corporate governance.
- Our approach tests whether CL firms are more likely to terminate poorly performing CEOs than non-CL firms.

Why CEO Turnover?

- Previous research argues that a necessary condition of effective corporate governance is that poorly performing managers are replaced
  - Macey (1997), Coffee (1999), Murphy (1999)
- Jensen and Ruback (1983), Shleifer and Vishny (1997) argue that the most important form of expropriation is by poorly performing managers staying on the job too long.
- Most importantly, a large body of research has supported the use of CEO turnover as a measure of the quality of corporate governance in the U.S. and abroad.
  - DeFond & Hung (2004), Gibson(2003), Volpin (2002), Dalha,McConnell & Travlos(2002)
- Further, increased transparency, better monitoring, stronger laws and better enforcement should make it easier to detect poor performance and provide incentives to replace top management.

Lel and Miller (2007)

- We gather detailed top management turnover data on 70,200 firm-year observations from 42 countries to evaluate the specific predictions of the bonding hypothesis
  - Do cross-listed firms have better corporate governance than non-CL firms?
  - If so, are US listings associated with the strongest protections affect governance the most?
  - Do firms located in countries with the weakest investor protections see the largest gain in governance?

	Civil Law	Common Law	Low Disclosure	High Disclosure	Low Anti Director Rights	High Anti Director Rights
Variable	**(1)**	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Log Assets	0.020***	0.030***	0.022***	0.025***	0.020***	0.032***
	[6.733]	[7.869]	[7.740]	[6.091]	[7.241]	[7.647]
Lagged Earnings Ratio	-0.001**	-0.254***	-0.001*	-0.003	-0.001**	-0.322***
	[-2.408]	[-6.620]	[-1.719]	[-0.441]	[-2.263]	[-6.613]
L2/3	0.078	0.092**	0.061	0.116**	0.044	0.118**
	[1.289]	[2.135]	[1.095]	[2.504]	[0.799]	[2.570]
L2/3 * Lagged Earnings Ratio	-1.378***	0.097	-0.954***	-0.143	-0.991***	0.148

Interpretation? The probability of replacing the CEO increases by 4.27% for Level 2/3 ADRs when we move from the top quartile to the bottom quartile of firm performance measured by the lagged ebit/ta ratio in civil law subsample

R144A	0.043	-0.016	0.072	-0.050	0.058	-0.055
	[0.553]	[-0.097]	[0.874]	[-0.338]	[0.734]	[-0.323]
R144A * Lagged Earnings Ratio	-0.696	0.551	-0.493	0.181	-0.650	0.577
	[-1.072]	[0.494]	[-0.774]	[0.175]	[-0.998]	[0.511]

Huson, Parrino, and Starks(2001) show that going from the top quartile to the lowest quartile in ebit/ta ratio increases the probability of CEO turnover by 2%.

Industry Effects (Two-digit SIC)	Yes	Yes	Yes	Yes	Yes	Yes
Year Effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	43,962	26,234	47,189	22,983	51,320	18,792
Pseudo R-squared	0.033	0.022	0.032	0.019	0.030	0.026
Mean Interaction	***-0.33******	***0.019***	***-0.23****	***-0.037***	***-0.23******	***0.029***
Effect	***[-3.272]***	***[0.416]***	***[-2.605]***	***[-0.789]***	***[-2.816]***	***[0.607]***
Mean Interaction	***-0.094***	***0.040***	***-0.017***	***-0.033***	***-0.028***	***0.042***
Effect	***[-0.706]***	***[0.547]***	***[-0.199]***	***[-0.375]***	***[-0.337]***	***[0.463]***
Mean Interaction	***-0.169***	***0.129***	***-0.116***	***0.041***	***-0.160***	***0.132***
Effect	***[-1.069]***	***[0.503]***	***[-0.789]***	***[0.177]***	***[-0.994]***	***[0.529]***

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What do we find?

1. CL firms are more likely to terminate poorly performing CEOs.
2. This effect is concentrated in exchange traded CL, rather than OTC, 144a, or even London Listings
3. Is strongest in firms from weak investor protection countries.
4. Robust to
   - Alternative performance measures (Accounting and stock-priced based)
   - Country, industry and year fixed-effects
   - Self-selection
   - Potential Labor Market Shifts
   - Excluding (1) Japan and UK, (2) Asian Crises period (3) Firms with large blockholders, (4) Financial and regulated industries (4) small firms

Overall, our results provide direct support for the major tenets of the bonding hypothesis

Suggests an actual channel thru which cross-listing improves governance

Show the U.S. legal environment reaches foreign companies which suggests that market based approaches to improve global corporate governance are possible.

Other applications of Governance Outcomes

- Wu (2008) WP
- Doidge, Karolyi, Lins, Miller Stulz (2008) JF forthcoming

Q2. Do the costs of securities regulation outweigh the benefits?

- While SEC registration and the corresponding disclosure requirements are a defining feature of U.S. capital markets, the economic impact of these laws are currently under debate both theoretically and empirically
- Perhaps nowhere is this more evident than in the controversy surrounding the effects of SEC registration and enforcement on foreign companies cross-listed on U.S. stock exchanges.
- This disagreement has led both academics and policy makers alike to debate whether the recent decrease in U.S. cross-listings is evidence that the costs of U.S. regulations, which include the 2002 Sarbanes-Oxley (SOX) Act, outweigh the benefits and consequently have rendered U.S. capital markets uncompetitive.
  - Li, and Wong (2005), Doidge, Karolyi and Stulz (2007), Chaplinsky and Ramchand (2007), Hostak, Lys, and Yang (2006), Li (2006), Litvak (2007), Marosi and Massoud (2006), Piotroski and Srinivasan (2007), Smith (2006), Woo (2006), Zingales (2007), and Hostak, Lys, and Yang (2006

Do the costs of securities regulation outweigh the benefits?

- Here again, the debate centers around trying to infer the answer from either the numbers of voluntary listing or delisting decisions and/or their valuation consequences.
- Lots of ways to calculate and/or interpret the same evidence.
- A different approach: Regulation Changes
  - *Escape from New York: The Market Impact of SEC Rule 12h-6 on Foreign Private Issuers* –Fernandes, Lel and Miller (2008) Working Paper

- Delisting from U.S. stock exchanges is relatively easy.
- In contrast, *deregistering* with the SEC is a considerably more difficult, if not an impossible proposition.
- Under the pre-2007 rules, an FPI can only deregister a class of its securities IF
  - the class is held by fewer than 300 U.S. residents (record holders), or
  - fewer than 500 U.S. record holders for FPIs with less than USD $10 million in assets.
- Often difficult to meet the security holder minimums given the difficulty in finding all the U.S. security holders and getting the final few to sell their securities.
  - monikers like "*roach motel*," "*hotel California*" and "*Venus flytrap*".
- "you can checkout any time you like, but you can never leave"

Escape from New York: The Market Impact of SEC Rule 12h-6 on Foreign Private Issuers –Fernandes, Lel and Miller (2008)

- On March 21st, 2007 the SEC approved new rules for deregistration by FPI, taking effect June 4th 2007.
- The new rule attempts to alleviate concerns about the competitiveness of the U.S. capital markets.
- As SEC Commissioner Paul Atkins stated in his speech at the March 21 open meeting, "There has been a lot of talk by a lot of groups lately about the competitiveness of the U.S. capital markets. One consistent theme in all of those discussions is that the U.S. needs to pay heed to the strength and growth of foreign markets, and U.S. regulators must ensure that our regulatory policies allow the U.S. markets to adapt to the changing face of capital formation. As I see it, this is not an argument for less -- or "light touch" -- regulation -- it is an argument for smart regulation. What we are doing today is an example of smart regulation, and I hope it is the start of a trend."

Research on Economic Impact of Disclosure Regulation

- 1933 Securities Act: Stigler 1964, Friend and Herman 1964, Robins and Werner 1964, Benston 1969/73, Jarrell 1981
  - Results of these studies heavily debated: Coffee (1984)
- 1964 Securities Act: Greenstone (2006) finds increased disclosure increased firm value
- 1999 Eligibility Rule: Bushee and Leuz (2005)
- Healy and Palepu (2001) note that the literature on the costs and benefits of disclosure regulation are “surprisingly sparse”.
  - In contrast to large literature on economic impact of mandated accounting standards changes
- All are for increases in mandated disclosure

Table 3: The Market Reaction to SEC Rule 12h-6

Panel A. Subsamples based on Investor Protection

Weak Investor Protection	N	Mean $\hat{\gamma}_i$	Median $\hat{\gamma}_i$	Strong Investor Protection	N	Mean $\hat{\gamma}_i$	Median $\hat{\gamma}_i$
Low Disclosure	114	-0.0019**	-0.003***	High Disclosure	427	-0.00007	-0.0006
Low Disclosure in Periodic Filings	101	-0.0016*	-0.0025**	High Disclosure in Periodic Filings	440	-0.00002	-0.0005
Low Accounting Standards	141	-0.0012*	-0.0021**	High Accounting Standards	400	-0.00019	-0.0008
Low World Bank Disclosure Index	152	-0.0017***	-0.003***	High World Bank Disclosure Index	389	0.00005	-0.0005
Civil Law	213	-0.0013***	-0.0002***	Common Law	328	0.0001	-0.0005
Low Judicial Efficiency	142	-0.0014**	-0.0029***	High Judicial Efficiency	399	-0.0001	-0.0005

What do we find?

1. The market did not react positively on average to 12h-6.
2. The market reaction was, in fact, *negative* for firms located in countries with poor disclosure and investor protection environments.
3. Little evidence that compliance costs explain the market reaction
4. Robust to
   - Excluding Canadian firms (largest number of CL firms)
   - Excluding Penny Stocks
   - Alternative announcement dates
   - SUR, OLS and Sefcik and Thompson (1986) estimation methods

Overall, our results provide the first empirical evidence (foreign or domestic) on the economic impact of mandated disclosure *deregulation*.

Provides evidence on the economic impact of one of the most important aspects of international cross-listings

Suggests that the costs of US regulations (including the 2002 SOX Act), do not outweigh the benefits.

The past as the future?: London Listings