

The Benefits and Costs of
Cross-listing in the United States

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Foreword

The Corona Visiting Scholars publishing program is the editorial byproduct of presentations by internationally recognized foreign professors who visit the Management School of the Universidad de los Andes for a brief period thanks to funds donated by the Corona Organization in 1996 to finance the visiting scholar program that bears its name.

Through the years, the Corona Distinguished Visitors Program has fostered valuable interchange among researchers and teachers, renewing and stimulating the School's academic environment. It has also strengthened links with the international academic community in various areas of management and produced valuable feedback about the School's orientation, problems and future plans.

Work by invited professors takes place the respective area of the School in such a way that it initiates a long-term relationship through joint research projects and extended arrangements such as visiting professorships.

The program also promotes travel by the School's professors to foreign academic institutions to strengthen the

School's strategic connections and create long-term relationships with academic peers in foreign institutions.

With more than 143 visitors coming from various North American, European, Asian, Australian and Latin American universities in the United States, France, England, Spain, China, India, Australia, Argentina, Brazil, Mexico and Venezuela, this series of publications is editorial testimony of the program's valuable contribution. The current issue, number 11 in a series, corresponds with one of the presentations made by Professor Tatiana Zalan of the School of Economics and Commerce at the University of Melbourne in Australia during her visit in August 2006.

*Publications Committee
June 2009*

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Introduction

This monograph is a synthesis of the author's research on the economic consequences of cross-listing in the United States. It excerpts several recently published papers where I, along with several co-authors, examine both the costs and benefits of international cross-listings¹.

¹ For more complete surveys of the cross-listing literature, see Karolyi (1998, 2006) and Benos and Weisbach (2004).

I. A Primer on American Depositary Receipts

Depositary Receipts were created in 1927 by J.P. Morgan as a means for U.S. investors to participate in the London Stock Market. A DR is a negotiable certificate issued by a depositary bank for a number of non-U.S. securities that are held by the depositary's custodian in the home market of the non-U.S. company. DRs are registered with the SEC and trade like any other U.S. security. They are quoted and pay dividends in U.S. dollars. DRs traded outside the U.S. are called Global Depositary Receipts (GDRs). Since the holder of a DR has the right to redeem the receipt for the underlying share, the DR and the underlying share are virtually perfect substitutes for each other, after adjusting for transactions costs. These costs include fees paid to the Depositary Bank for DR creation or cancellation.

Early DR programs were generally initiated at the request of investors, without company authorization. These "unsponsored" programs can have multiple registrar, transfer and paying agents. In the 1950s, several Australian and South African mining companies created the "sponsored" DR program. Under the sponsored program, a company signs an agreement with one depositary to be the sole agent for its DRs. The sponsored program gives more control of DRs to the firm, allowing it to compile ownership characteristics of its investors. In 1983, the Securities and Exchange Commission (SEC) required that all new DR programs must have company approval in order to be established.

DRs offer several potential advantages for U.S. investors seeking portfolio diversification: they allow for investment in countries which have restricted access to their primary equity market; they are denominated, and pay dividends, in U.S. dollars; the depository bank is responsible for the distribution of financial statements to investors; trading costs are lower; settlement occurs in the U.S., which may be faster and more reliable than in the home market, and withholding tax payments may be simpler. In addition, many DR programs can lead to greater company disclosure, such as full SEC reporting according to U.S. accounting standards.

Companies have a choice of four types of DR facilities: three levels of public offerings as well as private placement. Table 1 summarizes the characteristics of the DR programs by exchange, accounting standards, SEC registration, capital raised, time to completion and costs.

The least costly way for a company to cross-list its shares is to establish a "Level I" DR program. Level I DRs trade in the U.S. over the counter (OTC) "pink sheet" market and on some exchanges outside the United States. By filing a 12g3-2(b) exemption from the 1934 Exchange Act, the company does not have to comply with U.S. GAAP or full SEC disclosure. Fifty-six percent of the approximately 1500 DR programs are classified as Level I. Level II DRs are traded on the NASDAQ, AMEX, or NYSE, and are used by companies seeking greater liquidity and investor recognition. Major exchange DR programs, however, entail greater costs. The initial fee alone can exceed \$1 million. Firms that issue Level II DRs must also reconcile to U.S. GAAP, report quarterly and meet the listing requirements of the particular U.S. exchange where they trade. Because of the higher costs and more stringent reporting requirements, many firms choose a Level I DR program instead of a major exchange DR program.

While Level I and II DRs are created using existing shares, firms can also tap the U.S. capital markets via a public offering or a private placement of DRs. DRs have

evolved into one of the most popular tools for raising international capital. In 2008 alone, over \$14 billion dollars was raised through the DR market.

Table I. Characteristics of Depositary Receipt Programs traded in the U.S.^a

	Level I	Level II	Level III	144a
Primary Exchange	OTC “pink sheets”	NYSE, AMEX or NASDAQ	NYSE, AMEX or NASDAQ	PORTAL
Accounting Standards	Home Country Standards	U.S. GAAP	U.S. GAAP	Home Country Standards
S.E.C. Registration	Exempt	Full Registration	Full Registration	Exempt
Share Issuance	Existing Shares Only (Public offering)	Existing Shares Only (Public offering)	New Equity Capital Raised (Public Offering)	New Equity Capital Raised (Private Offering)
Time to Completion	10 Weeks	10 Weeks	14 Weeks	16 Days
Costs	≤ \$25,000	\$200,000 - \$700,000	\$500,000 - \$2,000,000	\$250,000 - \$500,000

Foreign securities traded in the U.S. are required to perform periodic reporting under the 1934 Exchange Act, provided that the company’s equity securities are held of record by 500 or more persons, of which 300 or more are U.S. residents. This requires quarterly reporting, filing the form 20-F in U.S. Generally Accepted Accounting Principles. Level I and 144a DRs are eligible for a 12g3-2(b) exemption from this requirement, and only have to supply to the SEC copies of information that the company makes public in its home country. Privately placed Depositary Receipts are also eligible for the 12g3-2(b) exemption. They trade between Qualified Institutional Buyers under SEC Rule 144a, which provides a safe harbor exemption from the registration requirements of the Securities Act of 1933.

^a Source: *Global Offerings of Depositary Receipts, A Transaction Guide* (The Bank of New York, 1995).

Level III DRs raise new equity capital in a public offering and trade on the NASDAQ, AMEX, or the NYSE. The issuer registers the offering under the 1933 Securities Act and reports under the 1934 Exchange Act. The company must meet full SEC disclosure requirements, comply with U.S. GAAP, report quarterly, and meet the listing requirements of the U.S. exchange where it chooses to list. Both Level II and Level III programs require the firm to complete Form 20-F, which is similar to a 10-K report. As of December 31st, 2008, there were over 400 Level II and Level III programs listed on the NYSE, AMEX, and NASDAQ.

Finally, Rule 144A Depositary Receipts (RADRs), are DRs that raise new equity capital via private placement. Rule 144A was adopted by the SEC in April, 1990

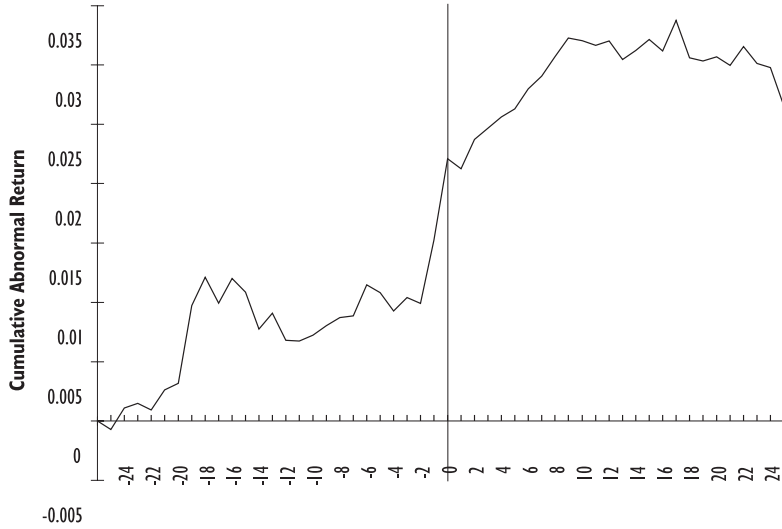
to increase the liquidity of privately placed DRs by allowing Qualified Institutional Buyers (QIBs) to trade among themselves without a holding restriction. The SEC defines QIBs as either institutions that manage at least \$100 million in securities or registered broker-dealers owning and investing \$10 million in securities of nonaffiliates. Prior to rule 144A, privately placed DRs could not be resold until they had been held by the investor for a three year period. RADRs are traded on PORTAL, a screen based automated trading system developed by NASD to support the secondary trading of Rule 144A securities. Despite these measures, the 144a market has remained illiquid, with the majority of trades occurring in unregulated offshore markets. The major advantage of 144a private placements, however, is that they are allowed an exemption from the 1934 Exchange Act and therefore can be used to raise capital without meeting the reporting and disclosure requirements of a U.S. public offering.

II. The share price and cost of capital impact of cross-listing in the U.S.: Miller (1999)

Early studies on the economic consequences on listing in the U.S. focused on the changes in the stock price surrounding the listing or announcement of the cross-listing. For example, Miller (1999) examines the market reaction to cross-listing for a sample of 181 firms from 35 countries that instituted their first Depositary Receipt program over the period 1985 to 1995. The study makes two significant departures from earlier studies: First, it focuses on the date the dual listing is announced. The extensive literature on firms that move from the OTC or NASDAQ to the NYSE demonstrates the importance of utilizing the announcement date rather than the listing date. Van Horne (1970), McConnell and Sanger (1984), Ying, Lewellen, Schlarbaum, and Lease (1977), Sanger and McConnell (1986), and Kadlec and McConnell (1994) all document positive abnormal returns to the announcement of an exchange listing. Second, the study examined the stock price reaction across each type of DR program. Each DR program trades off varying degrees of liquidity and investor recognition with disclosure requirements. For instance, firms can list their shares on the OTC "pink sheet", PORTAL, NASDAQ, AMEX, or the NYSE markets, but those listing on the NASDAQ, AMEX, or NYSE must reconcile their financial statements to U.S. Generally Accepted Accounting Principles (GAAP).

The first main finding from Miller (1999) is the finding of positive abnormal returns around the announcement date which provides evidence that firms benefit from listing shares outside their home market. Figure 1 summarizes the evidence for the 50 days surrounding the announcement of the initial DR program. Further, Miller (1999) finds that the average abnormal returns around the announcement of a DR program vary by exchange. Controlling for institutional and geographical differences in DR programs, there are significant differences in the stock price reactions that are related to barriers to capital flows. Abnormal returns are largest for firms that list on major U.S. exchanges such as NYSE or NASDAQ and smallest for firms that list on PORTAL. This finding is consistent with previous research suggesting that indirect barriers such as liquidity risk and low investor recognition segment capital markets. There is also weak evidence that direct barriers can cause market segmentation. Firms located in Chile, where legal barriers to capital flows are prevalent, have extremely large positive abnormal returns. Finally, contrary to the evidence on U.S. firms, the results presented here suggest that foreign firms that enter U.S. capital markets to raise new equity capital in a public offering experience a positive change in shareholder wealth. Those in a private offering experience a negative change in shareholder wealth. Overall, the results provide empirical support for the hypothesis that dual listing can mitigate barriers to capital flows, resulting in a higher share price and a lower cost of capital.

Figure I. Cumulative abnormal returns from day -25 before to day +25 after the announcement of a Depository Receipt program.



The daily abnormal returns are market model adjusted for each security. The daily abnormal returns are averaged across firms then cumulated. The sample is for 181 firms that listed shares as Depository Receipts over the period 1985 to 1995.

III. The effect of cross-listing on the information environment of the firm: Lang, Lins and Miller (2003)

Papers such as Miller [1999] document positive average abnormal announcement returns for non-U.S. firms that issue exchange-listed American Depositary Receipts (ADRs). Similarly, Errunza and Miller [2000] find a substantial decline in a firm's cost of capital after an ADR. These papers and others offer a number of explanations for why cross listing on a U.S. stock exchange adds value. However, a crucial component in almost all of these explanations is the firm's information environment. The notion that the information environment should be a function of cross listing is natural, since, as discussed in Coffee [2002], cross listing firms subject themselves to (1) increased enforcement by the SEC, (2) a more demanding litigation environment and (3) enhanced disclosure and reconciliation to U.S. GAAP. In addition, cross listing firms may face more scrutiny from investors, more pressure to provide guidance than they did in their home markets, and increased scrutiny from their auditors. Firms that list in U.S. markets are, in effect, "bonding" themselves to an increased level of disclosure and scrutiny. These changes in transparency could affect firm value by decreasing the cost of capital, increasing the cash flows that ultimately accrue to shareholders, or both.

Despite its theoretical importance, surprisingly little direct evidence on the relation between a firm's information environment and cross listing exists. One factor that makes testing this relation difficult is that it is not possible to directly measure a firm's information environment. One novel approach is taken in Lang Lins and Miller (2003) who use the characteristics of analyst forecasts as a proxy for the information environment. In particular, they focus on two measures: the number of analysts following the firm and the accuracy of analyst forecasts. Previous studies suggest that having more analysts with more accurate forecasts indicates a firm with a better information environment.

Lang, Lins and Miller (2003) document several interesting findings. First, they show that non-U.S. firms that cross list enjoy greater analyst coverage and increased forecast accuracy relative to other firms that are not cross-listed. Second, a time series analysis shows that the change in analyst coverage and forecast accuracy occurs around the cross-listing period. Third, they document that firms that have more analyst coverage and higher forecast accuracy have a higher valuation. Finally, Lang Lins and Miller (2003) show that ADR firms with greater improvements in their information environment around cross listing also experience larger increases in valuations, which is consistent with these firms enjoying a lower cost of capital or improved corporate governance.

These findings have important implications for several strands of research. The large literature on international cross-listings suggests that information disclosure plays a key role in the cross-listing decision. While theory predicts firms that cross-list on a more transparent exchange should be more highly valued, there has been little direct empirical evidence regarding the role of the information environment and its impact on cross-listing. The findings provide evidence that important changes occur in the information environment of firms around cross-listing and that these changes are rewarded with higher valuations by the market. In addition, since other factors such as investor protection and agency problems have been argued to be important to the cross-listing decision, the findings suggest control variables that may allow for a more detailed examination of other benefits to cross listing.

IV. The impact of cross-listing on CEO turnover: Lel and Miller (2008)

The bonding hypothesis of Coffee (1999) and Stulz (1999) posits that firms cross-listed on a major U.S. stock exchange have better corporate governance than non-cross-listed firms from the same country, *ceteris paribus*, since cross-listed firms are subject to strong U.S. investor protections. For example, cross-listed firms on U.S. exchanges must adhere to U.S. disclosure practices, which require them to reconcile their net income and shareholder's equity to U.S. GAAP, disclose the identity of majority shareholders (10% or greater), and follow detailed procedures during tender offers and going private transactions. These firms are also subject to far reaching U.S. investor protection laws such as the Foreign Corrupt Practices Act and, more recently, the Sarbanes Oxley Act. Cross-listed firms are also subject to punishment by U.S. law enforcement, both by the SEC as well as private investor law suits, and to increased scrutiny from intermediaries such as financial analysts and debt rating agencies². In contrast, listing on the OTC market or conducting a private placement allows substantial exemptions from these laws and regulations³. Specifically, the bonding hypothesis predicts that, *ceteris paribus*, (1) cross-listed firms will have better corporate governance than non-cross-listed firms, (2) the difference in governance between cross-listed firms and non-cross-listed firms will be greatest

² Coffee (2002) calls these intermediaries "financial watchdogs."

³ For example, these firms are not required to register under the Exchange or Securities acts and are therefore exempt from most civil liability provisions and do not have to follow U.S. disclosure practices (Doidge (2004)).

in the countries with the weakest investor protections, and (3) cross-listings that require the most stringent U.S. investor protections (i.e., on the NYSE, AMEX, or NASDAQ) will have the largest differences in corporate governance. In this way, cross-listing in the U.S. represents a market-based approach to increased investor protection.

While in theory a cross-listing in the U.S. should lead to more effective corporate governance, the ability of a cross-listing to serve as a bonding mechanism is under debate. On the one hand, several empirical studies examine the economic impact of cross-listing in the U.S. and find evidence that is consistent with the bonding hypothesis. This line of research finds that cross-listed firms from weak investor protection countries have larger stock price reactions (Foerster and Karolyi (1999), Miller (1999)), higher valuation (Mitton (2002), Doidge, Karolyi, and Stulz (2004a)), more scrutiny by financial analysts (Baker, Nofsinger, and Weaver (2002), Lang, Lins, and Miller (2003)), lower cost of capital (Errunza and Miller (2000), Hail and Leuz (2004)), better information environments (Bailey, Karolyi, and Salva (2005)), lower voting premiums (Doidge (2004)) and more access to external finance (Reese and Weisbach (2002), Lins, Strickland, and Zenner (2005)). However, ascribing the evidence contained in many of these studies directly to the bonding hypothesis is difficult given the well-known challenge in distinguishing among the various theories of cross-listing and the endogeneity issues inherent to this literature⁴.

On the other hand, the evidence in several recent studies suggests bonding via cross-listing in the U.S. is ineffective. For example, Siegel (2005) finds that the SEC and minority shareholders have rarely enforced U.S. laws against cross-listed firms and Lang, Raedy, and Wilson (2006) find that the accounting data of cross-listed firms from weak investor protection environments are of lower quality even though cross-listed firms are required to follow nominally

⁴ For example, Sarkissian and Schill (2006) argue that valuation gains to cross-listing are transitory.

similar accounting standards as U.S. firms. However, the approaches in these papers are not without their drawbacks, as Coffee (2002) and Benos and Weisbach (2004) suggest that measuring the incidence of legal actions may understate the deterrent benefit of laws and Leuz (2006) argues that disclosure quality differences between cross-listed and U.S. firms may not be clear evidence against bonding as cross-listed firms are allowed considerable discretion in preparing their financial statements to U.S. GAAP.

Another challenge researchers face when testing the bonding hypothesis is that it is often difficult to assess the *quality* of governance from observed *mechanisms* of governance because governance mechanisms often substitute or complement one another, a finding that Doidge, Karolyi, and Stulz (2004b) emphasize is dependant on the extent of a country's investor protections. Further, this issue is likely to be exacerbated for cross-listed firms, given the many financial and regulatory changes that take place around a listing (see, for example, Lang, Lins and Miller (2003, 2004).

In Lel and Miller (2008), rather than calculating the stock price consequences, legal enforcement incidents, or changes in governance mechanisms around a cross-listing to infer improvements in investor protections, they measure a direct outcome of corporate governance: the propensity to replace poorly performing CEOs. Why CEO turnover? Replacing poorly performing CEOs is argued to be a necessary condition for good corporate governance (Shleifer and Vishny (1989, 1997) and the sensitivity of top executive turnover to performance as a measure of the quality of corporate governance has been supported by a large number of studies in the U.S. and abroad, including recent research by Dahya *et al.* (2002), DeFond and Hung (2004), Gibson (2003), and Volpin (2002)⁵.

Lel and Miller (2008) compile a database of 70,976 firm-year observations from 47 countries from 1992 to 2003 to test the hypothesis that CEOs of cross-listed

⁵ For U.S.-based studies see Hermalin and Weisbach (2003) and citations contained therein.

firms are more likely to face termination when firm performance is poor. They find that the relation between CEO turnover and poor performance is stronger for cross-listed firms than non-cross-listed firms, and that the stronger turnover to poor performance relation for cross-listed firms is concentrated in firms listed on major U.S. exchanges (for example, Level 2 and 3 ADRs). Firms that list in the over-the-counter (OTC) market (Level 1), conduct private placements (Rule 144a), or even list in London do not have a significantly different relation between CEO turnover and performance from non-cross-listed firms. Further, we find that the increased relation between CEO turnover and poor performance for cross-listed firms is strongest in countries with weak investor protections. Overall, the results provide direct evidence that U.S. securities laws and regulations improve the corporate governance of cross-listed firms.

V. Regulatory responses to firm's cross-listing decisions: Fernandez, Le and Miller (2008)

While the previously surveyed literature in the monograph suggest that there are benefits to cross-listing in the U.S., there is also significant controversy surrounding the costs of SEC registration and enforcement on foreign companies cross-listed on U.S. stock exchanges, since once a firm becomes subject to U.S. regulations, these laws make it difficult, if not impossible, for it to deregister and thereby terminate its U.S. disclosure obligations. This disagreement has led both academics and policymakers 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 their benefits and consequently have rendered U.S. capital markets uncompetitive⁶.

In response to this debate, the SEC commissioner Paul S. Atkins announced on March 21, 2007 the approval of Rule 12h-6 which makes it considerably easier for foreign firms to deregister with the SEC. It is important to note that it is deregistration, not delisting, that is required to

⁶ See Berger, Li, and Wong (2005), Doidge, Karolyi, and Stulz (2007a), Chaplinsky and Ramchand (2007), Hostak, Lys, and Yang (2006), Li (2006), Litvak (2007), Leuz, Triantis, and Wang (2008), Piotroski and Srinivasan (2008), Smith (2006), Woo (2006), and Zingales (2007).

avoid ongoing SEC reporting obligations. Thus, Rule 12h-6 represents the first significant *deregulation* of U.S. disclosure requirements since the passage of the 1933/1934 Exchange and Securities Acts⁷.

In Fernandez, Lel and Miller (2008), they provide new evidence on the economic consequences of SEC registration and disclosure requirements by analyzing the market reaction to SEC Rule 12h-6. By examining a rare market-wide shock in mandatory disclosure regulation, they are able to provide new evidence on how investors value the U.S. registration of foreign firms.

Fernandez, Lel and Miller (2008) find that the market reacted negatively to the ability of firms from weak investor protection regimes to easily opt out of the stringent U.S. reporting and legal environment and revert to their less stringent home country environment. For example, they find that the market reaction is negative for firms located in countries with poor disclosure environments as well as for firms from countries with civil law legal origin and with low levels of judicial efficiency.

In contrast, they find that the market reaction was insignificant for firms located in countries with strong investor protections. Therefore, the results suggest that shareholders place the highest value on U.S. disclosure requirements when the levels of disclosure and investor protection are poor in the home country. In contrast to the country-level disclosure and investor protection results, we find much weaker evidence that proxies for compliance costs or financing needs explain the market reaction. Finally, Fernandez Lel and Miller (2008) also find that the negative abnormal returns are concentrated in firms that are currently complying with SEC disclosure requirements (e.g., level II and III ADRs), rather

⁷ Mandatory increases in disclosure regulations have also been extremely rare since the passage of the 1933/1934 Exchange and Securities Acts (e.g., the 1964 Amendments, the OTC Eligibility Rule of 1999, and the Sarbanes–Oxley Act of 2002).

than cross-listed firms exempted from registration requirements (OTC and Rule 144a ADRs). This suggests the economic impact of the rule is concentrated in firms currently subject to SEC registration. Overall, the results support the hypothesis that U.S. disclosure and investor protection laws have significant economic benefits, especially for cross-listed firms from poor investor protection regimes.

Fernandez, Lel and Miller (2008) also examine the voluntary listing and delisting decisions of firms surrounding the passage of Rule 12h-6. They find that in the 8 months following, the number of foreign firms that applied for voluntary delisting and deregistration climbed to an historical high and for the first time, the number of deregistrations exceeded that of new registrations. Fernandez, Lel and Miller (2008) also find that a number of the first firms to deregister under Rule 12h-6 had been previous targets of U.S. class action lawsuits or SEC enforcement actions. Finally, they document that the stock price reaction to the voluntary deregistration announcements following Rule 12h-6 is also inversely related to the quality of home country disclosure and investor protection environment.

VI. Conclusions

In this monograph, I surveyed and condensed several of my co-author and I's research on the economic consequences of international cross-listing. Academics and practitioners continue to debate the cost of benefits of international listings, and the research into this phenomena shows no signs of abatement.

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