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The spillover effect of disclosure rules and materiality thresholds: Evidence from profit warnings issued in Hong Kong market ☆

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A B S T R A C T

Dual-listed firms simultaneously follow the relevant rules in their home country and in their cross-listed country. In contrast, other firms only listed in the cross-listed country are only subject to the local regulations. Previous literature has found evidence that cross-listing can improve firms' information transparency because of more stringent listing rules in the cross-listed country. The existing research, however, has not paid enough attention to the potential influence of dual-listed firms and their home country institutional factors (e.g. unique disclosure policies) on other firms only listed in the cross-listed country (i.e. spillover effect). In the Hong Kong market, Chinese dual-listed firms are under the mandatory profit warning regulation of mainland China, but other firms listed only in Hong Kong only need to follow the voluntary disclosure rule of the Hong Kong Stock Exchange. Such a setting provides us with the opportunity to investigate a spillover effect, i.e. whether these Chinese dual-listed firms influence their peers only listed in Hong Kong to release profit warnings. We find that firms only listed in Hong Kong are more likely to issue profit warnings if their Chinese dual-listed peers have also issued warnings. We further find that this spillover effect increases with the market capitalization of Chinese dual-listed firms and increases with the market share of these firms before they dominate the industry. Lastly, due to an underlying duty to disclose material information in Hong Kong, the spillover effect is weaker for firms with large earnings surprises.

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"Usually advanced markets like the US, the UK and Australia do not have profit-warning requirements and I do not think Hong Kong should have such a requirement."

– Mark Dickens, HKSE

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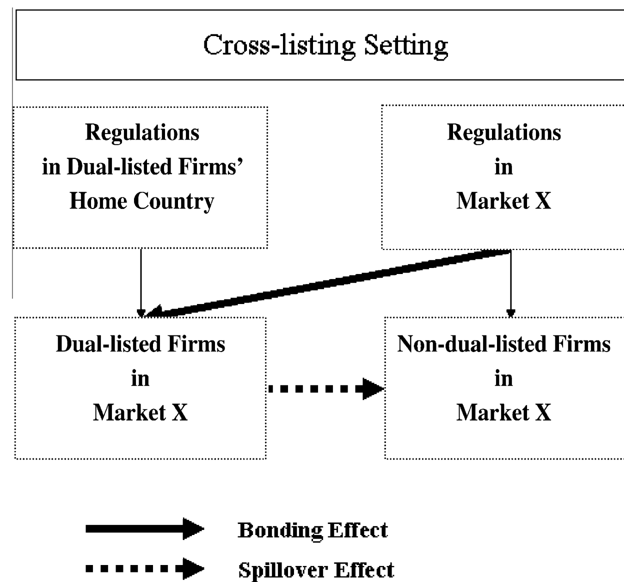

Fig. 1. Two effects in the cross-listing setting.

1. Introduction

Mark Dickens, the Hong Kong Stock Exchange's newly appointed listings head has urged the government to toughen penalties on companies that fail to disclose price-sensitive information to the market. But Mr. Dickens rejected suggestions that Hong Kong needed to follow the mainland in introducing a specific profit-warning threshold. Given that timely profit warnings can reduce information asymmetry and reduce profits from insider trading, setting regulatory standards appropriately requires intimate knowledge of different rules and their consequences. This study investigates the nature and extent of the externality from mainland China's profit warning regulation over listed firms in the Hong Kong market.

In a typical cross-listing setting (see Fig. 1), there are two groups of firms: cross-listed firms and non-cross-listed firms. Some of the cross-listed firms also issue shares in their own country ("dual-listed firms" hereafter). These dual-listed firms need to comply with two sets of regulations: the regulations in their own country and the regulations in the cross-listed country, Market X. In contrast, other firms only listed in Market X ("non-dual-listed firms" hereafter) merely need to comply with the regulations of Market X. Obviously, the regulations in Market X have an impact on these dual-listed firms, which we call the "bonding effect".[1] Meanwhile, it is possible that the regulations in the dual-listed firms' home countries can also affect the behavior of non-dual-listed firms in Market X through the influence of dual-listed firms, which we call the "spillover effect".

Up to now, most cross-listing literature has focused on the bonding effect on cross-listed firms. Recent empirical work shows that foreign firms with cross listings in the U.S. raise more external finance, have higher valuations, a lower cost of capital, higher analyst following and report higher quality accounting numbers than their counterparts in their own countries (Reese and Weisbach, 2002; Lang et al., 2003a,b; Doidge et al., 2004; Bailey et al., 2006; Hail and Leuz, 2006). However, it is important to remember that dual-listed firms are subject to the relevant laws and regulations in both their home countries and the cross-listed country. Licht (2003), Leuz (2006) and Leuz and Wysocki (2008) indicate that the existing research has not paid enough attention to the potential influence of institutional factors from the dual-listed firms' home countries (e.g. unique disclosure policies) on non-dual-listed firms' voluntary disclosure in the cross-listed country. Therefore, in this paper, we examine this "spillover effect", by exploring whether Chinese dual-listed firms that are required to follow mainland China's disclosure rules have an influence on other firms only listed in the Hong Kong market to make profit warnings.

Accordingly, our study focuses on the "spillover effect" of regulations and raises the research question: Does a spillover effect of regulation exist? Specially, we examine the spillover effect of mainland China's regulations on other firms only listed in the Hong Kong market (H shares, Red Chips and others) through the influence of Chinese dual-listed firms. We use a sample of 298 profit warnings in Hong Kong from 2003 to 2009 and find that Chinese dual-listed firms push the non-dual-listed firms in Hong Kong towards better transparency by issuing profit warnings. That is, non-dual-listed firms in Hong Kong are more likely to issue profit warnings if their Chinese dual-listed peers have also issued warnings. We further find that this spillover effect increases with the market capitalization of Chinese dual-listed firms and increases with the market share of these firms before they dominate the industry. The spillover effect, however, diminishes with an increase in the earnings surprise of the non-dual-listed firms. This implies that firm disclosure behavior is more likely to be

[1] That is, firms can opt into a foreign regime and thereby bond themselves to the more onerous disclosure, accounting and governance requirements and stricter enforcement regime of another country, which is called the bonding hypothesis (Coffee, 1999; Stulz, 1999).

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