Bonding to the Improved Disclosure Environment in the US: Firms' Listing Choices and their Capital Market Consequences

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Abstract

We examine whether current disclosure requirements affect foreign firms' decisions to list on a US exchange. We document that (1) while firms from a weak disclosure environment are more likely to cross-list and either trade OTC or be placed privately, they are less likely to list on an exchange in which firms are required to comply with US GAAP, (2) exchange-listing firms receive a higher valuation than non-exchange-listing firms, and (3) exchange-listing firms domiciled in a higher disclosure regime, who incur lower costs of US GAAP compliance, generally receive a higher valuation than exchange-listing firms from a lower disclosure regime.

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1. Introduction

The purpose of this study is to examine whether the US disclosure requirements for foreign registrants drive firms' listing choices and whether such choices have capital market consequences. The bonding hypothesis proposed by Coffee (1999, 2002) suggests that firms voluntarily choose to list (i.e., bond) in the US because a US listing enhances investor protection and reduces agency costs (see also Ball, 2001; Stulz, 1999; Reese and Weisbach, 2002).[1] As a consequence, bonding increases the public value of their shares by lowering cost of capital due to an increased shareholder base, increasing stock liquidity and growth opportunities, and improving reputation and visibility (the public value benefit perspective).

However, critics of the bonding hypothesis (e.g., Licht, 2003) argue that managers in weak protection countries might be reluctant to cross-list in the US because of the potential loss of private benefits (the private control benefits perspective). This agency theory perspective is consistent with the notion of "signaling-not-bonding," which suggests that better firms signal their business quality by listing in the US and joining their peers there, without much corporate governance improvement (e.g., Siegel, 2005).

Consistent with the private control benefit view, Doidge et al. (2004) document that: (1) firms domiciled in a jurisdiction where investor protection is stronger are more likely to bond because the cross-listing cost is likely to be lower; and (2) there is a cross-listing premium - Tobin's q for cross-listed firms is higher than for non-cross-listed firms. However, they do not find clear support for the private control benefit hypothesis with respect to the improved disclosure requirements at the cross-listing level. Given that some cross-listing firms are required to comply with US disclosure requirements (i.e., firms that choose to list on an organized exchange), the potential loss of private control benefits due to the higher disclosure level can be a concern to these firms.

Our research is further motivated by Leuz (2003), who argues that the main source of cross-listing benefits is not obvious and that the net benefit of bonding is difficult to assess. In particular, he notes that it is not clear whether the cross-listing effect associated with an improvement in the firm's information environment (which will increase firm value) derives from increased disclosure and/or stronger Securities and Exchange Commission (SEC) enforcement. He thus claims that studies that exploit the cross-sectional variation in cross-listing effects are likely to add value to the literature.

In this study, we test the private control benefit hypothesis by focusing on the fact that only exchange-listing firms incur the cost of complying with the accounting and disclosure rules and regulations in the US. Meanwhile, cross-listing firms that trade over-the-counter (OTC) as pink sheets or that are placed directly to qualified institutional investors (i.e.,

[1] Coffee (2002) defines bonding as the costs or liabilities an agent or entrepreneur will incur in order to increase stock price by assuring investors that it will perform its duties as promised. He argues that it is the mechanism by which firms incorporated in a jurisdiction with weak protection of minority shareholders voluntarily subject themselves to higher disclosure standards and stronger investor protection in order to attract investors who would otherwise discount stocks with high information risk related to poor disclosure and risk of expropriation from minority shareholders.