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WORBUS 808 No. of Pages 13
ARTICLE IN PRESS
Journal of World Business xxx (2016) xxx–xxx
Contents lists available at ScienceDirect
Journal of World Business
journal homepage: www.elsevier.com/locate/jwb

Mitigating the dual liability of newness and foreignness in capital markets: The role of returnee independent directors

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ARTICLE INFO

Article history:
Received 12 October 2015
Received in revised form 10 June 2016
Accepted 11 June 2016

Keywords:
Returnee independent directors
Liability of newness
Liability of foreignness in capital markets
Investor protection

ABSTRACT

Foreign firms undergoing an initial public offering in developed economies face a dual liability of newness and foreignness that can negatively impact the firm's ability to access capital. In this study, we examine the ability of returnee independent directors to overcome such a liability among 232 foreign listings in the U.S. We find that returnee independent directors positively impact the price premium of the foreign IPO. We also find that this relationship is contingent on the level of ownership retained by non-independent directors, the level of ownership retained by venture capitalists, and investor protection in the firm's country of origin.

1. Introduction

Foreign companies increasingly are seeking initial public offerings (IPOs) in stock exchanges in more developed economies such as the United States (U.S.) in order to obtain greater access to international capital (Hursti & Maula, 2007). Such firms face several challenges, particularly a dual liability of newness and foreignness in capital markets (Certo, 2003; Bell, Filatotchev, & Rasheed, 2012; Peng, Mutlu, Sauerwald, Au, & Wang, 2016). The liability of newness comes from their limited operational track records (Beatty & Zajac, 1997; Certo, 2003). The liability of foreignness derives from entering capital markets and institutional systems with which they are less familiar (Ahlstrom, Young, Nair, & Law, 2003; Peng & Su, 2014), and in which the investors may have a bias for home market firms (Bell et al., 2012; Humphery-Jenner & Suchard, 2013). As a result, foreign IPO firms generally suffer from a "legitimacy deficit" (Schmidt & Sofka, 2009: 461), and thus must build their legitimacy, or the "generalized perception or assumption that the actions of an entity [the firm] are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" with the investors (Suchman, 1995; p. 574). As recent news events suggest surrounding the legitimacy (and legality) of practices in firms such as Alibaba and Monsanto, building legitimacy has become increasingly crucial, and particular so for firms seeking IPO in overseas markets where firms may not yet have much reputation (Kowitt, 2016; The Economist, 2016; Zhao, Gu, Yue, & Ahlstrom, 2013). Thus, the question that arises, therefore, is: *How do foreign IPO firms build legitimacy among stock market investors in new, developed economies and overcome these key liabilities?*

Prior studies primarily grounded in an agency perspective suggest several governance-related legitimation strategies that might help mitigate the disadvantages faced by IPO firms (Certo, Daily, & Dalton, 2003), including inside ownership (Bell, Moore, & Al-Shammari, 2008), investment by venture capital (VC) firms (Ahlstrom & Bruton, 2006; Bruton, Filatotchev, Cahine, & Wright, 2010; Megginson & Weiss, 1991; Sanders & Boivie, 2004) and board independence (Bell, Filatotchev, & Aguilera, 2014; Bell et al., 2012). Such governance-related legitimacy drivers represent strategies that both domestic and foreign firms undertaking an IPO can use to alleviate investors' concerns. Given that foreign IPO firms face a dual liability of newness and foreignness in the foreign capital market (Certo, 2003; Filatotchev & Bishop, 2002; Higgins & Gulati, 2006), this study examines legitimation actions specifically useful for this type of firms. Specifically, we examine hiring returnee independent directors as a legitimation strategy for foreign IPO firms. A returnee independent director is a native who had work experience or had a business degree from a university abroad before returning back home to join a local firm's board. We argue that returnee independent directors serve as a "legitimacy bridge"

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http://dx.doi.org/10.1016/j.jwb.2016.06.004
1090-9516/

that connects a firm with its potential investors in a foreign host capital market – a market from which the returnee director had been based earlier (and is returning from).

We further argue that the distance a foreign IPO needs to travel along this legitimacy bridge is not the same for all firms; rather, the need for legitimacy building and development depends on other firm-level governance characteristics and macro-institutional environment in the firm's home country. Extant studies on legitimation processes tend to examine the various legitimization strategies separately, without paying attention to their substitutability or complementarities (e.g. Ahlstrom, Bruton, & Yeh, 2008). However, in the last number of years, scholars have found that legitimation strategies should not be considered in isolation from each other as they might complement or substitute for each other in addressing stakeholders' concerns (Li & McConomy, 2004). Indeed, Bell et al. (2012: 120) have specifically called for studies to "evaluate how these legitimation strategies can complement or perhaps substitute for one another." Therefore, we examine the interactive effects of legitimation strategies in overcoming dual liability of newness and foreignness in capital markets. Specifically, we examine a possible substitution between IPO valuation impacts of the returnee independent directors and two governance factors of an IPO firm: the retained ownership by non-independent directors and that of venture capital (VC) firms. These governance factors are traditionally associated with enhanced monitoring and incentive alignment processes in IPO firms and thus may weaken the benefits gained by the addition of returnee independent directors.

In addition, the effectiveness of legitimation strategies cannot be properly understood outside their institutional contexts (Peng, Sun, Pinkham, & Chen, 2009; Scott, 2013). As Ahlstrom, Levitas, Hitt, Dacin, and Zhu (2014: 572) argue: "Given the substantial variation in institutional environments, there is a need to better understand how different institutional arrangements help shape firm preferences and strategic choices." Indeed, the effectiveness of a particular legitimation strategy in foreign capital markets can hinge upon the home institutional environments (Bell et al., 2014). Bell et al. (2012: 119) added that "the impact of the institutional environment of a country on the likelihood of success of specific strategies . . . is a promising avenue for future research." Therefore, we examine how different institutional arrangements in the firm's host and home markets shape the effectiveness of returnee independent directors as a legitimation strategy.

Our research makes a number of specific contributions to the literature. First, as more research is needed on globalization of capital markets (Peng & Su, 2014) we contribute to research on the liability of newness and foreignness for firms listing in foreign capital markets. Specifically, we identify a legitimation strategy that is particularly important for foreign IPO firms, returnee independent directors on the firms' boards, which has been largely overlooked by prior research. Second, we expand our understanding of legitimation strategies adopted by foreign IPO firms by examining their substitutability. In particular, we examine the substitutability between returnee independent directors in foreign listed firms and the previously identified "good governance" practices for domestic firms, ownership retained by non-independent directors, and ownership retained by venture capitalists. Third, we delineate the boundary conditions of the legitimation strategies and explore how home country institutional arrangements shape the effectiveness of these strategies. Overall, we contribute to the literature on returnees and their impact on their economies by examining their role in corporate governance. This study further adds to the rigorous theoretical and empirical work that has emerged on real-world global business phenomena and the growth and development of global firms (Ahlstrom, 2010; Cui, Meyer, & Hu, 2014; Doh, Luthens, & Slocum, 2016) and capital markets (Peng et al., 2016; Peng & Su, 2014).

2. Theory and hypotheses

2.1. The dual liability of newness and foreignness in capital markets

Scholars have long recognized that IPO firms face a liability of newness (Leland & Pyle, 1977). At the time of the IPOs, investors face tremendous uncertainty associated with the quality of the IPO firms, as these firms typically have limited operational track records and resources (Chen, Hambrick, & Pollock, 2008). In addition, investing in these firms is risky because these firms have not demonstrated their willingness and ability to protect investors' interests (Certo, 2003; Filatotchev & Bishop, 2002). As a result of these risks and uncertainties, investors tend to discount the IPO firms' valuation (Filatotchev, Chahine & Bruton, 2016).

In addition to the liability of newness, foreign listed firms also face the liability of foreignness in capital markets. The international business literature has long recognized that a firm experiences liabilities when they do business outside of their home market (Bhanji & Oxley, 2013; Caves, 1971). Such a liability of foreignness can apply to both firms physically operating in a foreign market and those seeking capital in foreign markets (Bell et al., 2012). Scholars have offered a wide variety of reasons for the presence of liability of foreignness in capital markets, including institutional distance between a home and a host country (Chan, Covrig, & Ng, 2005), the cultural distance between a home and a host country (Beugelsdijk & Frijns, 2010), host market investors' information costs (Kang & Stulz, 1997), and host-market investors' unfamiliarity with foreign IPO firms (Sarkissian & Schill, 2004). In particular, for foreign IPO firms, the biggest concern for investors is that protection of their interests might be less in a foreign country than in their home country (Bell et al., 2012; Moore, Bell, & Filatotchev, 2010).

Prior studies have argued that foreign IPO firms could mitigate their dual liability, and build legitimacy in the eyes of foreign investors, by sending signals of firm quality (Bell et al., 2012). Research has found that whereas domestic IPO firms used governance-related signals, such as enhanced monitoring and incentive alignment to overcome the liability of newness, foreign IPO firms can also adopt these strategies to address investors' concerns (Bell et al., 2008, 2014). However, to the extent that foreign IPO firms face additional challenges concerning the liability of foreignness in capital market, an investigation of legitimation strategies which are particularly effective for such firms is an important area for research.

2.1.1. Returnee independent directors as a legitimation factor

We propose that returnee independent directors could serve as a signal of high firm quality, and thus enhance a foreign listed firm's legitimacy. An effective signal of firm quality that impacts the firm's legitimacy has two chief characteristics: observability and cost (Connelly, Certo, Ireland, & Reutzel, 2011).

First, observability refers to whether outsiders, in this case foreign investors, are able to notice the legitimacy signals of firms undergoing an IPO outside their home economy. In order to undertake an IPO, the owners and managers must prepare a standard and extensive set of documents for potential investors, including the prospectus. In the prospectus, a firm must include biographical information on all the directors (Certo, 2003; Higgins & Gulati, 2006). For foreign firms, a unique aspect of a director's background is whether the director is a returnee, or an individual who has worked or received education overseas and has now returned to his or her home country. Hence, potential investors are