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# The stock market reaction to losing or gaining foreign private issuer status

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## ABSTRACT

The U.S. Securities and Exchange Commission designates foreign-domiciled firms with securities trading in the U.S. markets as either foreign private issuers (FPIs) or domestic filers and permits exemptions from U.S. domestic securities regulation for firms that qualify as FPIs. We study the stock market reaction to foreign-domiciled firms that lose or gain FPI status for an arguably exogenous reason while maintaining their cross-listing status. After loss of FPI status, foreign firms are required to comply with U.S. domestic issuers' continuous filing requirements, such as filing quarterly financial statements using U.S. GAAP, disclosure of insider trading, and compliance with corporate governance requirements of U.S. domestic issuers. We document a significantly positive market reaction when foreign firms lose their exemptions and must comply with regulatory requirements of U.S. domestic issuers. Further, we find that the market reacts negatively to an increase in financial statement requirements and reacts positively to fully adopting U.S. corporate governance requirements.

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## 1. Introduction

In 1979,<sup>1</sup> the U.S. Securities and Exchange Commission (SEC) adopted its current regulatory framework governing foreign-domiciled firms. The framework permits foreign-domiciled firms to follow regulatory and disclosure requirements that are less stringent than the requirements for U.S. domestic issuers, but typically more stringent than their home-country requirements. A significant literature examines the economic consequences of cross-listing in (and de-registering from) the U.S. and initiating (ceasing) compliance with the requirements of foreign private issuers. Less well understood is whether investors care about the exemptions granted to foreign private issuers (FPIs). Using a unique setting, we provide evidence about whether the U.S. stock markets value the disclosure and regulatory exemptions currently granted to FPIs.

To study the costs and benefits of the two different levels of regulation for foreign-domiciled firms in the U.S., we exploit that some foreign-domiciled firms *change* FPI status over time, primarily due to events that are likely involuntary and outside managers' direct control in the spirit of [Gow et al. \(2016\)](#). When foreign-domiciled firms *lose* their FPI status with the SEC, they continue their listing in the U.S. but become subject to the same, stricter regulatory requirements as U.S. domestic

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<sup>1</sup> Adoption of Foreign Issuer Integrated Disclosure System, Exchange Act Release No. 16,371 (Nov. 29, 1979).

issuers. Conversely, when foreign-domiciled firms that are U.S. domestic filers with the SEC *gain* FPI status, they continue their U.S. listing but are permitted exemptions from certain regulatory requirements. Looking at foreign domiciled firms that lose or gain their FPI status with the SEC allows us to investigate some of the – possibly unintended – economic consequences of two-tiered reporting requirements. Moreover, we are able to document how the market perceives specific differences in requirements (e.g., financial statement disclosures vs. corporate governance). Identifying the specific consequences for firms that lose their FPI status informs regulators regarding which requirements the market views as beneficial versus costly.

Our setting provides an opportunity to test whether and how the U.S. stock markets value the exemptions from U.S. domestic reporting requirements because our sample firms remain cross-listed with their shares trading in the U.S. before and after their change in FPI status. Thus we can study the effect of switching to a different regulatory system while holding the country, enforcement, and shareholder protections more constant. The cost of this relatively clean test is that we sacrifice a larger sample size.

Whether stock market value tends to increase when a firm moves from FPI disclosure and regulatory requirements to the requirements for U.S. domestic issuers is not obvious. Loss of FPI status results in increased disclosure and regulatory requirements. Shareholders may view increased requirements as value enhancing if greater transparency and stricter corporate governance limits managers' and/or controlling shareholders' ability to extract rents (e.g., Stulz, 1999; Coffee, 1999, 2002; Core et al., 2006; Berger and Hann, 2007). In contrast, increased costs of compliance<sup>2</sup> with additional standards may decrease firm value (e.g., Zhang, 2007; Leuz et al., 2008; Li, 2014). Law practitioners overwhelmingly focus on the benefit of maintaining FPI status to avoid the additional compliance costs of U.S. domestic issuers (e.g., Cohn and Vivero, 2013). On the other hand, the exemptions may not be significant enough to affect firm value. In adopting the Foreign Issuer Integrated Disclosure System in 1979, the SEC determined the requirements for FPIs were sufficient to protect U.S. investors. Frost and Kinney (1996) find similar correlations between earnings and stock returns for foreign-domiciled (FPIs) and U.S. domiciled issuers matched on size and industry, suggesting that foreign issuers' lower disclosure levels may not, on average, impair the usefulness of earnings for valuing FPIs.

To determine whether the stock market on balance views the change in reporting requirements as beneficial or costly, we examine the short-window stock market reaction to firms' announcement of change in FPI status.<sup>3</sup> Specifically, we calculate the cumulative abnormal return (CAR) for the three-day period centered on the announcement of a change in FPI status. Our results are consistent with U.S. domestic reporting and regulatory requirements providing incremental value to shareholders above FPI requirements as we find a statistically significant 2.30% CAR for firms that lose their FPI status. We find a statistically insignificant negative CAR of –1.79% for firms that gained FPI status.

In addition to examining the market's overall reaction to a change in FPI status, we examine how the market reacts to exemptions FPIs receive from U.S. domestic regulatory requirements, which may differentially affect firm value. Specifically, we identify the exact requirements that changed within each firm, and classify them into three broad categories: *Financial Statements*, *Disclosure of Insider Information*, and *Corporate Governance*. The reporting requirements grouped in the *Financial Statements* category relate to the timeliness, quality and quantity of information disclosed in the financial statements. These requirements are costly to implement but likely provide more transparent reporting thereby reducing agency costs. *A priori* the effect on firm value is ambiguous. The reporting requirements grouped in the *Disclosure of Insider Information* category relate to the disclosure of inside information, such as insider ownership and sales as well as private disclosure of management information. The predicted effect of this category of requirements is unclear as theory indicates either positive or negative trading profits related to the disclosure of insider information (see Huddart et al., 2001, 2006). The last category of reporting requirements grouped in *Corporate Governance* relate to corporate governance. Theoretical and empirical evidence supports that stronger (weaker) corporate governance is associated with better (poorer) operating performance, which the market rewards with higher prices. An alternative view is that the optimal governance structure will vary from firm to firm (Baysinger and Butler, 1985). Thus, losing FPI status may force firms away from their optimal governance structure and negatively impact operating performance.

Overall, our results suggest that shareholders view the extensive disclosure requirements relating to the *Financial Statements* category as costly while they find that *Corporate Governance* related requirements add value. Understanding how the stock markets value the various requirements may help U.S. regulators focus on the key differences. Our results add to a

<sup>2</sup> For example, following its loss of FPI status, Alpha & Omega Semiconductor Limited reported in its Management Discussion & Analysis the following increase in costs, "In addition, we incurred \$1.1 million of professional fees related to the conversion of our financial statements under IFRS to U.S. GAAP and a \$0.9 million incremental expense associated with the requirements of being a public company." These additional costs are not trivial as they represent 2.9% and 2.4% of the firm's reported net income, respectively.

<sup>3</sup> A fundamental challenge for event studies in the cross-listing literature is that the market reaction to the U.S. cross-listing announcement may signal positive news about firms' growth prospects rather than for foreign firms' bonding with U.S. laws and institutions. Our study is less likely to be affected by this issue for three reasons. First, FPI status changes for the majority of firms in our sample because of an increase or decrease in their U.S. investor base, which is outside the direct control of managers. Second, the announcement of a change in FPI status is unlikely to signal a change in firms' growth prospects. If, for example, improvements in a firm's U.S. growth prospects attract U.S. investors, which causes the change in FPI status, the information related to growth prospects should be incorporated in the firm's stock price prior to the announcement of the change in FPI status. Third, we document that the change in the type and number of FPI requirements is associated with the market reaction to the announcement of the change in status.

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