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On the fortunes of stock exchanges and their reversals: Evidence from foreign listings

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ABSTRACT

Using a sample that provides unprecedented detail on foreign listings for 29 exchanges in 24 countries starting from the early 1980s, we show that although firms list in countries with better investor protection, they are less likely to list in countries with *excessively stronger* investor protection. We provide evidence based on ex ante firm and market characteristics and ex post listing outcomes that our findings are due to lack of investor interest in firms from environments with much weaker investor protection. We also argue that our findings, together with a general trend of improvement in investor protection in many firms' countries of origin, can explain why US and UK exchanges have attracted an increasing number of foreign listings during our sample period.

1. Introduction

The existing literature maintains that firms predominantly choose countries with the strongest investor protection, such as the US and the UK, for their foreign listings, because these countries offer bonding through their superior laws and/or a greater ability to monitor their market participants (Coffee, 1999; Stulz, 1999).

In this paper, using a novel dataset that is unprecedented for both international exchanges and time-series coverage, we show that although firms list in countries with better investor protection than their own, they are less likely to list in countries with *excessively stronger* investor protection. In other words, while firms list abroad to subject themselves to additional monitoring and scrutiny, there is a limit to the degree of monitoring and scrutiny they can achieve.

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We argue that, consistent with the literature on bonding (Doidge et al., 2004; Doidge, 2004), firms would want to commit to the highest governance standards to decrease their cost of capital. However, firms from environments with very weak investor protection fail to attract investor interest in the countries with the highest governance standards.[1] The lack of interest makes a foreign listing in exchanges with much stronger investor protection unfeasible (or undesirable). Improvements in corporate governance in the country of origin could therefore allow firms to decrease the gap in investor protection and to list in countries with the strongest investor protection.

This interpretation of the empirical evidence helps explain the increasing popularity of the US and the UK as venues for foreign listings: US and UK exchanges, which had approximately 40% of all foreign listings at the beginning of the 1980s (and less than 34% in 1990), now account for approximately 60% of foreign listings. We show that, during the early 1990s, for over 75% of our sample firms, corporate governance in the country of origin was so weak that their most likely cross-listing destinations were exchanges in countries with corporate governance weaker than the US, the country with the strongest investor protection according to most metrics. The adoption of laws and regulations improved corporate governance around the world (De Nicoló et al., 2008), and by 2006, for less than 50% of the sample firms, investor protection in the US was too strong. Firms from an increasing number of countries thus started to list in the US.

In the rest of the paper, we develop a number of tests to scrutinize whether investor demand indeed plays a role in driving the non-monotonic effect due to the differences in investor protection on the probability of a foreign listing. First, if the lower probability of a foreign listing in countries with much stronger investor protection is driven by investor demand and is not the outcome of firms' (unconstrained) decisions, we should observe that even firms in which the insiders' incentives to maximize firm value are strongest, for instance, because ownership is highly concentrated, do not list in countries with much stronger investor protection.[2] Consistently, we find that firms with concentrated ownership are even more inclined to list in exchanges with better investor protection. Nevertheless, as the difference in investor protection between the exchange country and the firms' country of origin grows too large, firms are less likely to list in that exchange, independent of the level of ownership concentration, suggesting that these firms are unable to attract investor interest.

Second, to further test our hypothesis that the non-monotonic effect of differences in investor protection on the probability of a foreign listing depends on investor demand, we exploit temporary changes in investor demand in the exchange country. In particular, we use the aggregate valuations of the exchange as a proxy for investor demand driven by investor sentiment. After having shown that this proxy is likely to at least partially capture investor sentiment in the exchange country, we show that firms from countries with much weaker investor protection are more likely to obtain a listing in a strong investor protection country when investor sentiment in that country is strong. In these situations, investors are known to be less attentive to firms' fundamentals, and this appears to include the quality of corporate governance in the origin countries of the firms.

Third, we validate our interpretation of the findings on the determinants of the propensity to list in different foreign exchanges, exploring some ex post outcomes that capture investor interest for cross-listed firms. Even for firms that have obtained a foreign listing, large differences in investor protection between the country of origin and the exchange country should be associated with relatively less investor interest, if investor demand indeed plays a role. Our first indicator of investor interest in the foreign exchange is the proportion of trading that takes place in the foreign country. We find that while more foreign trading occurs in the foreign exchange if this offers better investor protection than the firm's country of origin, the extent to which foreign trading takes place in the foreign exchange decreases as the difference in investor protection between the exchange country and the firm's country of origin grows too large.

[1] Portfolio investors are known to invest more in firms with strong corporate governance (Giannetti and Simonov, 2006; Leuz et al., 2009). Furthermore, Kim, Sung and Wei (2011) show that investors are more likely to invest in firms with corporate governance standards similar to firms in their origin countries.

[2] Insiders in firms with concentrated ownership have weaker incentives to extract private benefits of control and thus strongest incentives to commit to the highest standards of corporate governance.