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Cross-listings and liquidity commonality around the world[☆]



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ABSTRACT

In this paper, we investigate the effects of international cross-listings on commonality in liquidity. We find that cross-listings have asymmetric effects on cross-listed stocks' liquidity commonality that include reducing the stocks' liquidity commonality with the local market and increasing the stocks' liquidity commonality with the host market. We also find that the negative impact of cross-listings on home liquidity commonality is more pronounced for stocks from countries with high market segmentation, an opaque information environment, and a poor institutional infrastructure. These results suggest that cross-listings reduce the vulnerability of stocks' liquidity to aggregate liquidity shocks in the local market.

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1. Introduction

Many researchers suggest that international cross-listings may provide a firm with potential benefits, including expansion of the firm's shareholder base and improvement of the firm's

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information environment and investor protection (e.g., Stapleton and Subrahmanyam, 1977; Errunza and Losq, 1985; Alexander, Eun, and Janakiramanan, 1988; Foerster and Karolyi, 1999; Stulz, 1999; Coffee, 2002; Reese and Weisbach, 2002; Doidge, Karolyi, and Stulz, 2004, 2009). Because the shareholder base, investor protection, and information quality drive commonality in liquidity (Karolyi, Lee, and Van Dijk, 2012), a question of whether and how international listings influence cross-listed stocks' liquidity commonality naturally arises.

Commonality in liquidity among stocks bears important implications for investors. Empirical evidence shows that liquidity commonality is a systematic risk factor and that investors require compensation for a stock whose liquidity co-moves with market liquidity (e.g., Acharya and Pedersen, 2005; Lee, 2011). This finding necessitates an understanding of what factors affect commonality in liquidity. While many researchers have documented the existence of liquidity commonality in many countries, others have focused on which factors drive variations (or changes) in liquidity commonality in international markets, both within and across countries [e.g., Chordia, Roll, and Subrahmanyam, 2000; Hasbrouck and Seppi, 2001; Coughenour and Saad, 2004; Kamara, Lou, and Sadka, 2008; Hameed, Kang, and Viswanathan, 2010; and others investigate the factors that drive liquidity commonality in the U.S., whereas Karolyi, Lee, and Van Dijk (2012) examine the determinants of liquidity commonality in international markets].

To advance the understanding of liquidity commonality, we explore the impact of cross-listings on liquidity commonality. We use an extensive intraday data set that covers 22,381 firms across 39 markets over a 12-year period from 1996 to 2007 to measure stocks' liquidity commonality, along with data on cross-listings in the U.S. market [issued as American Depositary Receipts (ADRs)] and the global markets [issued as Global Depositary Receipts (GDRs)]. For the sake of completeness, we consider how international listings affect both the home liquidity commonality and the host liquidity commonality of cross-listed stocks.¹

We predict that cross-listings can lead to the lower home liquidity commonality and the higher host liquidity commonality of cross-listed stocks. These effects are because of two reasons. First, cross-listings can entice international investors to move part of their trading activity on cross-listed stocks from the home market to the host market (Levine and Schmukler, 2006). In addition, cross-listings can attract new international investors, who would otherwise not participate, to trade cross-listed stocks abroad (Domowitz, Glen, and Madhavan, 1998; Foerster and Karolyi, 1999). This trading migration and expansion can have two possible effects: the impact of existing foreign investors' correlated trading activity on cross-listed stocks in the home market may be diminished, which lowers the liquidity commonality of cross-listed stocks with the home market liquidity²; conversely, a cross-listed stock's liquidity in the home market (i.e., a parent stock's liquidity) may become correlated with the cross-listed stock's liquidity in the host market (i.e., a host stock's liquidity), which may be caused by the trading activity of international investors who gain the ability to trade cross-listed stocks in both the home and host markets.³ Because the host stock's liquidity tends to co-move with the host market's aggregate liquidity due to common factors in that market, this cross-listing-induced liquidity correlation leads to greater co-movement of the parent stock's liquidity in the home market with the host market's aggregate liquidity.

Second, international listings, particularly in the U.S., can enhance the level of protection for cross-listed firms' investors due to these listings being subject to stricter laws, regulations, and scrutiny in the host market, according to the bonding hypothesis (Coffee, 1999, 2002; Stulz, 1999; Reese and

¹ For convenience, we refer to the co-movement of a cross-listed stock's liquidity in the home market with the home market's liquidity as the cross-listed stock's home liquidity commonality. We refer to the co-movement of a cross-listed stock's liquidity in the home market with the host market's liquidity as the cross-listed stock's host liquidity commonality. Details on the estimation of these commonality measures are in the next section.

² Institutional investors' correlated trading activity causes stocks' liquidity to co-move (e.g., Kamara, Lou, and Sadka, 2008; Koch, Ruenzi, and Starks, 2010). Given that foreign investors account for a significant proportion of institutional ownership in a country (e.g., Ferreira and Matos, 2008), it is reasonable to argue that foreign investors' correlated trading activity affects liquidity commonality. Indeed, Karolyi, Lee, and Van Dijk (2012) rely on foreign institutional ownership as a proxy for the prevalence of institutional investors.

³ For brevity, "cross-listed stocks in the home market" and "cross-listed stocks in the host market" are sometimes referred to as "parent stocks" and "host stocks," respectively.

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