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Do political institutions affect the choice of the U.S. cross-listing venue?

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ABSTRACT

We study the impact of political institutions on foreign firms' choice of their U.S. cross-listing venue. Using two measures of the quality of political institutions (the political rights index and the political constraint index) and controlling for various firm-level and country-level characteristics, we show that foreign firms from countries with weak political institutions are more likely to cross-list in the U.S. via the over-the-counter market and less likely to cross-list on one of the main U.S. exchanges. Further, we show that firms originating in countries where political and legal institutions are weak are more likely to choose either the main U.S. exchanges or Rule 144A as compared to over-the-counter programs.

1. Introduction

Foreign firms from a wide set of countries continue to cross-list their shares on U.S. markets. Firms can cross-list their shares in the U.S. mainly through American Depositary Receipts (ADRs) or direct

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listings. Firms that decide to cross-list on U.S. markets can choose exchange-listed programs that are traded on one of the major U.S. exchanges (i.e., NYSE, NASDAQ, and AMEX) and mainly consist of Level II and III ADRs and direct listings. Alternatively, foreign firms can choose unlisted programs that are traded on the over-the-counter (OTC) market (including Level I ADRs) or on Private Offerings, Resales and Trading through Automated Linkages (PORTAL), also called Rule 144A. Indeed, in 2010, 39 foreign firms, nearly three times more than in 2009, chose to cross-list on the major U.S. exchanges through ADR programs. Moreover, in 2010, 60 foreign firms from 23 countries chose OTC depositary receipt programs. As of December 2010, 407 depositary receipts were listed on NYSE and NASDAQ and 779 OTC depositary receipts were available to investors. According to the latest U.S. Federal Reserve statistics and Bank of New York Mellon estimates, depositary receipts accounted for 6.4% of all equity portfolio investment in the U.S. at the end of 2010.[1]

Foreign firms choose to cross-list on U.S. markets for many reasons, including raising new funds at a lower cost (Reese and Weisbach, 2002; Lins et al., 2005; Doidge et al., 2009), increasing their visibility (Baker et al., 2002), improving the liquidity of their shares and broadening their shareholder base (Pagano et al., 2002; Aggarwal et al., 2007), and bonding themselves to stringent U.S. rules to protect their minority shareholders when the legal institutions of their domestic countries are weak (e.g., Coffee, 1999; Stulz, 1999; Reese and Weisbach, 2002; Doidge, 2004; Doidge et al., 2004, 2009). The testing of this "bonding" hypothesis has led to a burgeoning empirical literature on the role of legal institutions in determining the choice of a U.S. cross-listing venue (e.g., Reese and Weisbach, 2002; Boubakri et al., 2010). Recently, the political economy literature has challenged the law-and-finance literature and argues that strong legal institutions without sound political institutions in place cannot offer a high investor protection as investors cannot be sure about the outcome of the polity over their investment horizon (Roe and Siegel, 2009). Furthermore, investor protection does not only depend on laws in place but also on the confidence that these laws will be enforced in the presence of a strong and independent judicial system, which in turn depends on the strength of the political institutions (Eleswarapu and Venkataraman, 2006).

As of yet, the impact of *political institutions* on the U.S. cross-listing decision and the choice of the *U.S. cross-listing venue* has not yet been examined. The objective of this paper is to fill this gap and to examine how political institutions affect the choice of the U.S. cross-listing venue (OTC, PORTAL, and exchange-listed programs). In this paper, we examine whether political institutions exercise a first-order (direct) impact on the choice of the cross-listing venue as well as an indirect impact through a legal channel as political institutions condition the effectiveness of the legal system (e.g., Eleswarapu and Venkataraman, 2006; Roe and Siegel, 2011) that has been shown to affect the choice of the U.S. cross-listing venue (e.g., Boubakri et al., 2010; Reese and Weisbach, 2002). Indeed, Roe and Siegel (2011) examine the link between political instability and financial development and find that political instability leads to financial backwardness, independently of the legal origin channel. Recent studies have examined the impact of political institutions on credit spreads, gross spreads of IPOs, and equity trading costs. For example, Qi et al. (2010), using a political rights index, find that the cost of debt is higher for firms originating in countries with weaker political rights. Chen and Hao (2011) find that political institutions in the issuers' home markets affect the underwriters' gross spreads of ADR IPOs. In the same vein, Eleswarapu and Venkataraman (2006) show that the trading costs of NYSE-listed ADRs are lower for foreign firms domiciled in countries with more efficient judicial systems, better accounting standards, and more stable political systems. To our knowledge, no study has yet examined the direct link between political institutions and the choice of the U.S. cross-listing venue; this paper is thus the first to assess this relation.

We contribute to the literature on cross-listing and political economy in several ways: First, we examine the political determinants of the choice of the cross-listing venue while controlling for the strength of legal institutions. Indeed, by including the quality of political institutions as a determinant of the choice of the U.S. cross-listing venue, we examine this choice from a political economy perspective. Controlling for the strength of political and legal institutions allows us to control for the

[1] *Source*: The Depositary Receipt Market: 2010 Yearbook, February 2011, BNY Mellon, Depositary Receipts. These statistics do not include direct listing, which is mainly used by Canadian firms.