

# **FIN536**

# **CORPORATE GOVERNANCE**

**Lecture 13 Cross-Border Investing**

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# TODAY'S AGENDA

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- Foreign Institutional Investors
  - Equity home bias puzzle
  - “*Do foreigners invest less in poorly governed firms?*” By Leuz, Lins and Warnock, RFS 2008
  - “*Protection of minority shareholder interests, cross-listings in the United States, and subsequent equity offerings*”, By Reese and Weisbach, JFE, 2002

# 1. FOREIGN INSTITUTIONAL INVESTOR

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- Domestic sources of outside finance are limited in many countries (Giannetti and Koskinen, 2010)
  - Many capital markets have been liberalized and foreign capital has become an increasingly important source of finance (Bekaert, Harvey, and Lumsdaine 2002).
  - It is important to understand factors that influence whether foreign investors provide capital to a country's firms.

# 1.1. EQUITY HOME BIAS PUZZLE

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- The proportion of foreign assets held by domestic investors is too small relative to what is implied by standard portfolio theory
- This is puzzling since observed returns on national equity portfolios suggest substantial benefits from international diversification.
- Why?

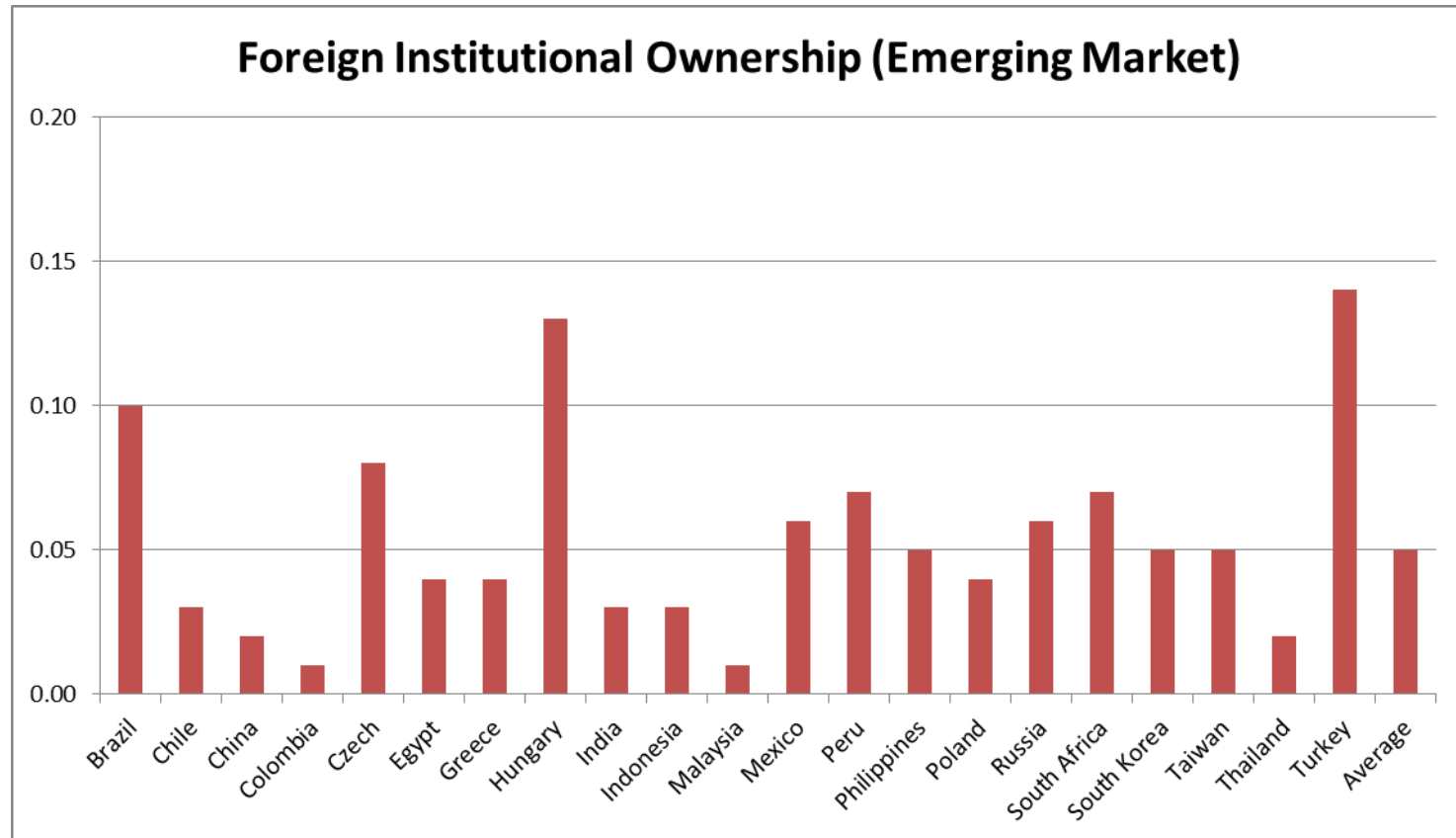
# 1.1. EQUITY HOME BIAS PUZZLE

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- Foreign institutional ownership
  - FactSet/LionShares database
  - mutual funds, pension funds, bank trusts, and insurance companies
  - Percentage of the total holdings of foreign institutions

# 1.1. EQUITY HOME BIAS PUZZLE

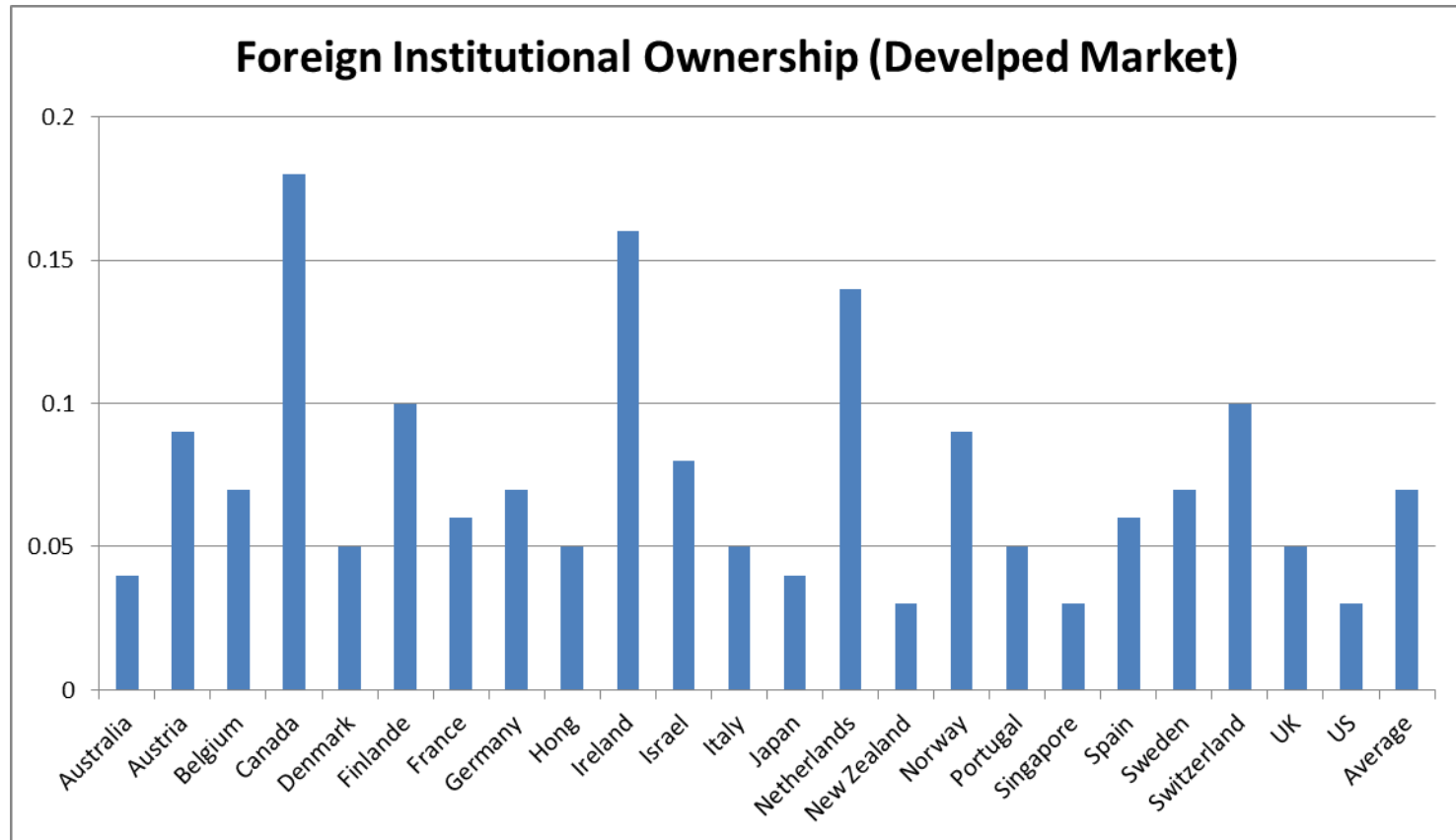
- Foreign institutional ownership for the period 2000 to 2011



Source: Syungjin Han (2014)

# 1.1. EQUITY HOME BIAS PUZZLE

- Foreign institutional ownership for the period 2000 to 2011



Source: Syungjin Han (2014)

# 1.1. EQUITY HOME BIAS PUZZLE

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- One hypothesis is that capital is internationally immobile across countries,
  - yet this is hard to believe given the volume of international capital flows among countries.
- Another hypothesis is that investors have superior access to information about local firms or economic conditions
  - this seems to replace the assumption of capital immobility with the assumption of information immobility



# 1.1. EQUITY HOME BIAS PUZZLE

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- Other explanation?
  - In some countries, like Belgium, holding stocks of foreign companies implies a double taxation on dividends, once in the country of the company and once in the country of the stockholder, while domestic stock dividends are taxed only once

# 1.1. EQUITY HOME BIAS PUZZLE

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- Kang and Stulz (1997)
  - Foreign holdings are relatively large in firms with large export sales
  - Foreigners invest in firms that they are better informed about
  - Thus, it can be argued that the home bias is driven by informational asymmetries

# 1.1. EQUITY HOME BIAS PUZZLE

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- Grinblatt and Keloharju (2000)
  - They emphasize that the degree of sophistication matters when studying investors in the Finnish market.
- Foreign investors are sophisticated informed investors
  - Grinblatt and Keloharju (2000) shows that the portfolios of foreign investors outperform the portfolios of households in Finland
  - Karolyi (2002) documents that foreign investors in Japan equities outperformed Japanese individuals and institutions during the Asian financial crisis period

# 1.1. EQUITY HOME BIAS PUZZLE

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- Positive relation with foreign ownership
  - the market liquidity of a firm's shares
  - its presence in the international goods and services markets
  - firms that are listed on international stock exchanges
- Negative relation with foreign ownership
  - ownership concentration
- Rational investors prefer firms about which they are better informed

## 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- “*Do foreigners invest less in poorly governed firms?*” By Leuz, Lins and Warnock, RFS 2008

## 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- “The fundamental issue for everyone involved in financial markets today, regardless of company or country, must be to maintain high standards—legal, regulatory, and ethical—that breed trust and confidence. . . . **Capital will flee** environments that are unstable or unpredictable—whether that’s a function of lax corporate governance, ineffective accounting standards, a lack of transparency, or a weak enforcement regime. Investors must see for themselves that companies are living up to their obligations and embracing the spirit underpinning all securities laws.”  
(William Donaldson, Chairman of the U.S. Securities and Exchange Commission, 2005)

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- Poor corporate governance is one factor that draws considerable attention from outside investors and regulators.
- Institutional investors frequently claim that they avoid foreign firms that are poorly governed.
- Regulators are concerned that weak governance and low transparency hinder foreign investment and impede financial development

## 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- At the same time, outside investors who fear governance problems and expropriation by insiders can reduce the price they are willing to pay for a firm's shares.



# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- Foreign investors are at an informational disadvantage relative to local investors
  - Brennan and Cao 1997, Kang and Stulz 1997, Choe, Kho, and Stulz 2005
- Information asymmetries between foreign and local investors are particularly pronounced
  - the evaluation of a firm's governance structure
  - the scope for expropriation by controlling insiders

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- In many countries, business transactions, financing arrangements, and, ultimately, corporate governance are shaped
  - not by arm's length dealings
  - but by relationships among a tightly knit group of controlling families and managers.
- Understanding these relationships require
  - an intricate knowledge of political connections, banking relations, family social status, and connections among the business elite, all of which foreigners are less likely to have.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- How can information asymmetries influence the investment decisions of foreign investors?
  - First, they give rise to an adverse selection problem when investors transact in foreign markets
  - As a result, investors underinvest in foreign stocks because they do not expect to receive a fair return based on the prices at which locals would transact.
  - Choe, Kho, and Stulz (2005) find that for Korean stocks prices move more against foreign investors than domestic investors before trades

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- How can information asymmetries influence the investment decisions of foreign investors?
  - Second, once an investment is made, firms with suspect governance structures require more monitoring than well-governed firms and this is likely to be more costly for foreign investors.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- How can information asymmetries influence the investment decisions of foreign investors?
  - In addition, poorly governed firms often actively hide the extent of their governance problems and expropriation activities, for instance, by providing opaque financial statements and managing earnings (e.g., Fan and Wong 2002; Leuz, Nanda, and Wysocki 2003).
  - Local investors are probably better equipped to unravel these activities, resulting in lower monitoring costs.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- How can information asymmetries influence the investment decisions of foreign investors?
  - Finally, understanding insider relationships is arguably more important in countries where outside investors are poorly protected, and certainly more costly in countries where firms provide little information publicly.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- This paper studies 4,409 firms from 29 countries to assess
  - whether and why concerns about corporate governance result in fewer foreign holdings.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- As there can be a host of reasons why foreign investors avoid or seek stocks from a particular country,
  - such as the degree of market integration, benefits from diversification, transaction costs, restrictions on capital flows, proximity, and language,
- The authors control for country-fixed effects in our tests, and analyze which stocks U.S. investors choose *within* a given country



# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- Information problems faced by U.S. investors play a central role
  - the negative relation between insider control and foreign holdings is more pronounced in countries with weak disclosure rules and poor shareholder protection

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- For foreign investors, information problems for firms with potentially problematic governance structures play an important role.
  - Stringent disclosure requirements make it less costly to become informed about potential governance problems.
  - They level the playing field among investors, making it less likely that locals have an information advantage.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- For foreign investors, information problems for firms with potentially problematic governance structures play an important role.
  - Strongly enforced minority shareholder protection reduces the consumption of private control benefits and thus decreases the importance of information regarding these private benefits.
  - In contrast, low disclosure requirements and weak investor protection exacerbate information problems and their consequences.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- Are information problems at the core of the holdings?
  - Use proxies for poor information flows to outsiders.
- Leuz, Nanda, and Wysocki (2003) and Haw et al. (2004) show that earnings management is more pervasive in countries with weak investor protection and in firms where ownership structures are more conducive to outsider expropriation.
- These prior findings support the notion that information flows to outside investors are particularly poor in countries and firms with weak governance.

# 1.2. GOVERNANCE AND FOREIGN INVESTORS

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- Are information problems at the core of the holdings?
  - U.S. holdings are lower for firms that engage in more earnings management
  - U.S. holdings are further reduced when firms with opaque earnings also have high levels of insider control
- In countries with low securities and disclosure regulation, foreigners shy away the most from firms where insiders are in control and earnings management is high.

# 1.3. CROSS-LISTING

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- “*Protection of minority shareholder interests, cross-listings in the United States, and subsequent equity offerings*”, By Reese and Weisbach, JFE, 2002

# 1.3. CROSS-LISTING

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- Non-US firms cross-list in the United States to increase protection of their minority shareholders
- Cross-listing on the NYSE or Nasdaq subjects a non-US firm to a number of provisions of US securities law, and requires the firm to conform to US GAAP.
- It therefore increases the expected cost to managers of extracting private benefits, and commits the firm to protect minority shareholders' interests.

# 3. CROSS-LISTING

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- Cross-list on an exchange (NYSE or Nasdaq) in the United States will obligate the firm
  - to conform to generally accepted accounting principles (US GAAP),
  - to file reports with the US Securities and Exchange Commission (SEC),
  - to comply with the requirements of the exchange on which it lists,
  - to some extent conform to US securities laws.



# 3. CROSS-LISTING

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- It thus provides a mechanism by which foreign firms can voluntarily subject themselves to some shareholders' protections under US securities laws.
- For firms that want access to US capital markets without the voluntary bonding, the over-the-counter (OTC) market and PORTAL (Rule 144a) provide such an opportunity

# 3. CROSS-LISTING

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- **American Depositary Receipts (ADRs)**
  - ADRs are negotiable certificates that represent a foreign company's publicly traded equity or debt.
  - Sponsored ADRs are created when, at the request of the company, an American broker purchases the company's shares on its home stock market and delivers them to a custodian bank.
  - The custodian bank issues Depositary Receipts, which trade either on NYSE/Nasdaq, OTC, or on PORTAL

# 3. CROSS-LISTING

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- Some firms (primarily Canadian and Israeli) choose to list their equity directly on a US exchange
  - The listing and reporting requirements for firms with direct cross-listings are essentially the same as for firms with an ADR

# 3. CROSS-LISTING

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- The relation between subsequent equity issues, shareholder protection, and cross-listings:
  - (1) Equity issues increase following all cross-listings, regardless of shareholder protection.
  - (2) The increase should be larger for cross-listings from countries with weak protection.
  - (3) Equity issues following cross-listings in the US will tend to be in the US for firms from countries with strong protection and outside the US for firms from countries with weak protection