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Lowering the Cost of Rent: How IFRS and the Convergence of Corporate Governance Standards Can Help Foreign Issuers Raise Capital in the United States and Abroad

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Lowering the Cost of Rent: How IFRS and the Convergence of Corporate Governance Standards Can Help Foreign Issuers Raise Capital in the United States and Abroad

Kyle W. Pine*

I. INTRODUCTION

Since the early 1990s the United States has experienced a dramatic growth in the number of foreign firms choosing to trade their shares in U.S. markets.¹ Meanwhile, Europe and other markets have not experienced this effect to the same extent.² In part, this growth is attributable to the popularity of American Depository Receipts ("ADRs")³ that increased throughout the 1990s, with the number of depository programs increasing from 352 in 1990 to 1800 by 1999.⁴ More generally, though, there has been

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¹ J.D. Candidate, 2010, Northwestern University School of Law.
⁴ An ADR is a negotiable instrument issued by a U.S. depositary bank and represents an ownership interest in a specified number of securities that are held by the depositary bank. They provide the ADR holder with the same income and voting rights as the underlying shares and are treated like other securities in the United States. Id. at 2660.
⁵ Coffee, supra note 1, at 1770; see also J.P. Morgan, http://www.adr.com/Home/TickerLookUp.aspx (showing that as of November 7, 2009, J.P. Morgan had 3226 ADRs listed on its website) (click "search" for total results) (last visited
an observable worldwide growth in stock market capitalization since the 1990s with an increasing number of foreign issuers choosing to cross-list their shares abroad, usually in the United States.

Traditional explanations for why firms choose to cross-list have focused primarily on access to trade in more liquid markets. These theories postulate that firms cross-list to overcome market segmentation caused by such factors as regulatory restrictions, taxes, and informational constraints in order to reach more investors. In doing so, firms are able to spread their risk across a greater pool of shareholders, leading to a lower cost of capital. These theories predict that firms initially will experience a higher equilibrium market price upon cross-listing, with diminished returns afterwards due to stabilization in the market. However, two observations have called the validity of these traditional explanations into question. First, studies have indicated that cross-listing results in significantly higher rates of return that do not diminish over time. Second, with the increasing globalization of financial markets and instantaneous electronic communications, an explanation based on tapping segmented pools of investors seems incomplete. A more convincing theory for why firms cross-list, attributed to John C. Coffee and accepted by numerous scholars in recent years, is the bonding theory of cross-listing.

The bonding theory postulates that firms cross-list their shares in order to voluntarily subject themselves to a market and a jurisdiction that has stricter disclosure standards and a greater threat of enforcement. In effect,

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5 See Coffee, supra note 1, at 1773 (comparing market capitalization growth to GDP with a ratio increase from a mean of 31% in 1990 to 62% in 2000).
6 See id. (noting that as stock markets grew, the ratio of market capitalization listed abroad to total market capitalization grew at a greater rate than market capitalization to GDP, particularly in emerging markets).
7 Id. at 1779; Larry E. Ribstein, Cross-Listing and Regulatory Competition, 1 Rev. L. & Econ., 97, 111 (2005).
8 Coffee, supra note 1, at 1779; Ribstein, supra note 7, at 111.
10 See Foerster & Karolyi, supra note 9, at 988-95 (reporting that the stock prices of cross-listing firms seemed to initially increase and then eventually decline after listing abroad); see also Gordon J. Alexander et al., Note, Asset Pricing and Dual Listing on Foreign Capital Markets, 42 J. Fin. 151, 157-58 (1987) (reporting the same).
11 See Coffee, supra note 1, at 1780 (citing Darius P. Miller, The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts, 51 J. Fin. Econ. 103, 104 (1999)) (finding an observable trend of increasing returns from the date firms announced their intention to cross-list, particularly for firms listing on the NYSE or Nasdaq rather than those listing on only over-the-counter markets).
12 Coffee, supra note 1, at 1757.
13 Id. at 1767 n.28.
14 See id. at 1780-81 (noting that, in particular, cross-listing on a U.S. stock exchange
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by voluntarily assuming the obligations set forth in strong securities markets, firms are able to “rent” another country’s securities law and enforcement, while at the same time bypassing their home countries’ restrictions which prevent an adoption of such similar regulation. The firms that choose to cross-list do so because they understand that regulatory regimes that provide strong investor protection help to convince outside investors of the firm’s commitment to protecting their interests. This, in turn, may reduce the discount potential investors place on a firm’s shares and lead to a lower cost of capital.

Under the bonding theory, cross-listing has consequences for both the home jurisdiction of cross-listing firms and the target jurisdiction. Cross-listing incentivizes home-country jurisdictions to modify existing laws and regulations to complement those in the target jurisdiction in order to stem the flow of exiting firms and to entice such firms to stay. This pressure creates both an incentive and an opportunity for convergence efforts in disclosure requirements and corporate governance requirements across different regulatory regimes. However, where divergence in regulatory standards persists, cross-listing firms must weigh the benefits of cross-listing against the cost of complying with the disclosure requirements and corporate governance laws of target countries. Often, target countries will exempt foreign firms from certain regulatory obligations in order to entice

requires the listing firm to recognize minority investor rights and to provide meaningful disclosure because: “(1) the listing firm becomes subject to the enforcement powers of the Securities and Exchange Commission (SEC); (2) investors acquire the ability to exercise effective and low-cost legal remedies, such as class actions and derivative actions, that are simply not available in the firm’s home jurisdiction; and (3) entry into the U.S. markets commits the firm (at least when it lists on an exchange or Nasdaq) to provide fuller financial information in response to SEC requirements and to reconcile its financial statements with U.S. generally accepted accounting principles (GAAP)”).

15 See Ribstein, supra note 7, at 98–99 (describing this scenario as a limited type of jurisdictional choice situation where firms choose to opt into an alternative, often stricter, regulatory regime, while not fully opting out of their home country regime: “[o]pt-out requires the default jurisdiction to consent not to use its jurisdiction over the moving firm to impose its own regulation”).

16 See id. at 104 (arguing that submission to strong regulatory regimes signals to potential investors a firm’s commitment to forego distributing the firm’s assets to owners and managers). But see Amir N. Licht, Cross-Listing and Corporate Governance: Bonding or Avoiding?, 4 Cen. J. Int’l L. 141, 162–63 (2003) (arguing that many firms that cross-list may actually be trying to avoid better governance).

17 Ribstein, supra note 7, at 104.

18 Id. at 99.

19 Id.; see also Coffee, supra note 1, at 1804–08 (describing efforts by regulatory regimes in both Germany and Brazil to create new “high standards” markets in an effort to stop the migration of listings and trading in the United States).

20 See discussion infra Part II (discussing the opportunities and impediments to regulatory convergence).

21 Ribstein, supra note 7, at 120.
cross-listing.\textsuperscript{22} However, this arguably has a contrarian effect to the bonding theory as it dilutes the bond or assurance cross-listing firms send to investors regarding the protection afforded by the target country's regulatory regime.\textsuperscript{23} Thus, there is an overall benefit created by the convergence in high-quality regulatory standards in that it equalizes the cost of compliance across jurisdictions while still maintaining the benefits to firms attributed to the bonding theory.

Specifically, the adoption of International Financial Reporting Standards ("IFRS") and the push towards corporate governance convergence provides an opportunity for cross-listing firms to further benefit under the bonding theory.\textsuperscript{24} The adoption of IFRS, as a high-quality, transparent regulatory standard, coupled with convergent corporate governance standards, can eliminate additional costs of compliance across jurisdictions. This, in turn, will allow firms to reduce their cost of capital and increase liquidity within the framework of the bonding theory.\textsuperscript{25}

This comment develops this argument as follows. Part II explains further why firms choose to "rent" the securities laws of other countries under the bonding theory. Specifically, Part II will describe what types of firms look to cross-list and further develop how both home countries and target countries react to cross-listing. Part III discusses how convergence of disclosure requirements, specifically the adoption of IFRS, is helping to lower the cost for firms choosing to cross-list in the context of the goals of bonding. Part IV discusses the impediments to the convergence of corporate governance across different jurisdictions. Part V concludes.

II. SETTING THE STAGE: THE EFFECTS OF CROSS-LISTING UNDER THE BONDING THEORY

The basic premise of the bonding theory is that cross-listing on an exchange in a market that has strong investor protection commits the listing firm to recognizing minority shareholders' rights and to presenting

\textsuperscript{22} See id. at 121–22 (discussing, from the perspective of the United States, how political pressure in target jurisdictions may lead to regulatory exemptions for cross-listing firms).

\textsuperscript{23} See Coffee, supra note 1, at 1782 (arguing that while enhanced disclosure offered by U.S. securities regulations increases a bond for cross-listing firms, requiring compliance of high-quality corporate governance standards is also important).


\textsuperscript{25} Id. The data examined by Daske et al. demonstrated that the mandatory adoption of IFRS by firms across the world resulted in market liquidity increases, lower cost of capital, and an increase in equity valuations. However, significantly, the data showed that the capital-market benefits occurred only in countries promoting transparency and strong legal enforcement. Id.
increased transparency and disclosure.\textsuperscript{26} In doing so, a firm is able to increase shareholder confidence, which in turn reduces the discount potential investors place on the firm’s shares and leads to a reduction in the cost of capital.\textsuperscript{27}

One source of evidence for the bonding theory consists of studies finding significant positive returns upon firms announcing plans to cross-list their shares in the United States, with such returns not dissipating over time.\textsuperscript{28} Significantly, data indicates an added premium exists if a cross-listing firm is listed on the NYSE or Nasdaq as opposed to over-the-counter markets.\textsuperscript{29} Additionally, data indicates an added premium on return from foreign firms in emerging markets choosing to cross-list in the United States versus foreign firms from developed markets.\textsuperscript{30} Another study, focusing on a comparison of foreign firms that cross-list in the United States with those that do not, found positive valuation differences in favor of the former.\textsuperscript{31} Essentially, these findings demonstrate that the United States, in contrast to weaker regulatory regimes, provides the strong investor protection that attracts foreign firms to cross-list. More specifically, U.S. securities laws and reporting requirements build investor confidence because:

\begin{itemize}
  \item[(1)] the issuer faces strict liability for material misstatements or
\end{itemize}

\textsuperscript{26} Coffee, supra note 1, at 1780.
\textsuperscript{27} Ribstein, supra note 7, at 104.
\textsuperscript{28} Miller, supra note 11, at 111.
\textsuperscript{29} See id. at 111–14 (finding that upon announcement of an intention to cross-list in the United States, firms experienced positive abnormal returns, with returns being nearly double for firms listing on the NYSE or Nasdaq in comparison to over-the-counter markets; foreign firms that only did private placements under Rule 144A had insignificant abnormal returns).
\textsuperscript{30} See id. at 115 (finding cross-listing firms from emerging markets had nearly double the cumulative abnormal returns); cf. Foerster, supra note 9, at 994 tbl. 4 (finding a positive, permanent market reaction for Asian firms cross-listing in the United States). Research on corporate governance has found several Asian countries have corporate governance standards that are inadequate to the protection of minority shareholders from the risk of the influence of controlling shareholders. See Coffee, supra note 1, at 1789 (citing Stijn Claessens et al., \textit{Disentangling the Incentive and Entrenchment Effects of Large Shareholdings}, 57 J. Fin. 2741 (2002)). This supports an explanation for why Asian firms would experience a positive, permanent market reaction according to the bonding theory. See generally Chen Y. Wu, \textit{Consequences of Cross-Listing in the US: Changes in Leverage and Corporate Governance} (Aug. 27, 2008) (unpublished Ph.D. dissertation, Arizona State University) (on file with author), available at http://wpcarey.asu.edu/fin/upload/Draft082708.pdf (finding, from a sample of 510 firms cross-listing in the United States, evidence that firms from emerging markets reduce their leverage much more than firms from developed markets).
\textsuperscript{31} See generally Craig Doidge, G. Andrew Karoly & Rene M. Stulz, \textit{Why are Foreign Firms Listed in the US Worth More?}, 71 J. Fin. Econ. 205 (2004) (finding that foreign firms listed in the U.S. have much larger Tobin’s Q ratios, a measure of growth opportunities, in comparison to firms from the same country that are not listed in the U.S.; this phenomenon is coined the “cross-listing premium”).
omissions; (2) a powerful engine of private enforcement (e.g., the contingent fee-motivated plaintiff's bar) stands ready to enforce U.S. legal rules; and (3) more reliable gatekeepers (e.g., U.S. underwriters and auditors) have conducted a "due diligence" investigation into the offering, motivated in part by their own high liability for negligent errors or omissions.  

A. Characteristics of Cross-listing Firms

As indicated above, the bonding theory recognizes certain characteristics of both the firms that choose to cross-list and the regulatory regimes that cross-listing firms choose to use. Generally speaking, cross-listing firms in strong regulatory markets, like the United States, usually have higher market valuations, greater leverage, and better earnings prospects compared to firms that do not cross-list. These firms demonstrate a willingness to give up some private benefits of control in order to obtain equity financing at a lower cost of capital.

Additionally, cross-listing firms have been observed to come from two major sources: (1) firms from countries with inadequate reporting requirements and accounting standards and (2) firms from civil law jurisdictions that are dissatisfied with the protection afforded to minority shareholders. Consequently, these firms have sought out regulatory regimes that provide the greatest protection to the rights and expectations of minority shareholders, which have been found to be in common law jurisdictions. In contrast, civil law jurisdictions have been found to protect the rights of concentrated ownership with an emphasis on maximizing the private benefits of control for a few controlling shareholders, often at the expense of minority shareholders.

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32 Coffee, supra note 1, at 1788.
33 Coffee, supra note 1, at 1766 n.23.
34 See Miller, supra note 11, at 104 (finding that in the mid 1990s 73% of non-U.S. companies establishing ADRs came from emerging market countries); see also Kent Hargis, International Cross-Listing and Stock Market Development in Emerging Economies, 9 INT'L REV. ECON. & FIN. 101, 102 (2000) (noting that in 1989, only two Latin American companies were cross-listed in U.S. markets, compared to 106 by 1999).
36 See Ribstein, supra note 7, at 100 (explaining that in civil law countries corporations are predominately controlled by fewer shareholders who own a significant portion of stock versus common law countries where corporations are generally owned by dispersed shareholders, with none holding enough stock to have significant control).
37 Id.; see also Coffee, supra note 1, at 1764–65 ("[F]irms that decline to migrate to 'high disclosure' exchanges will be disproportionately those with controlling shareholders who prefer to maximize their receipt of the private benefits of control rather than to maximize the share price of their firm's publicly-held minority shares."). Coffee argues that this may lead to a situation of competitive pressures producing specialized securities markets servicing
The benefits afforded by dispersed ownership include risk diversification, promotion of entrepreneurial activity, and increased trading resulting in the reflection of pertinent information more quickly into share prices. Furthermore, evidence has shown that firms in countries with laws and institutions that provide greater protection of the rights of minority shareholders have a lower cost of capital than firms in other countries. The United States may arguably be regarded as the best regulatory regime for dispersed shareholder protection, and thus it has attracted the most foreign firms looking to cross-list shares. Consequently, such migrations by firms have had effects on an international level in terms of changes both in local country regulatory requirements and target country regulatory requirements, particularly in the United States.

B. Home Country Characteristics

Under the bonding theory, cross-listing firms are seeking ways to increase their equity financing at a lower cost of capital by utilizing stronger regulatory laws and enforcement than what is available in their home countries. This begs the question of why these firms are unable to rely on changes in their own countries in order to promote laws protecting dispersed ownership structures. This can arguably be done by cross-listing firms demanding changes in local laws or by local securities, legal, and accounting professionals advocating change so as to encourage firms not to cross-list in the first place. However, there are several obstacles to such changes and to the convergence of international regulatory regimes, including political impediments, differences in market structure and the goals and objectives of a country’s regulatory system, and historical and cultural differences.

First, firms seeking to change local laws in favor of laws advocating

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38 Ribstein, supra note 7, at 100.
39 Id.
40 See supra notes 1–6, 29 and accompanying text.
41 See supra notes 26–31 and accompanying text.
42 Ribstein, supra note 7, at 101.
43 Id. at 117.
dispersed ownership and protection of minority shareholders' interests may face opposition from well-established interest groups.\textsuperscript{47} For example, incumbent firms under centralized ownership control in underdeveloped countries may oppose change because improved disclosure rules and enforcement may reduce the competitive advantage of incumbents' market presence and reputation, while giving new entrants the opportunity to enter and compete for profits.\textsuperscript{48} Additionally, changes in laws may be opposed by other interested parties, like labor organizations and banks, who cater to controlling shareholders' needs.\textsuperscript{49} Thus, regulatory standards that advocate increased disclosure and transparency are at odds with the interests of powerful, incumbent firms with controlling shareholders.

Second, a change towards protection of minority shareholders' interests may involve the need to overhaul a country's basic securities regulation framework.\textsuperscript{50} In particular, underdeveloped countries often do not have viable regulatory systems to support an initial regulatory and corporate governance reform.\textsuperscript{51} As such, effective regulatory change depends not only on formal rules, but also on broader institutional and legal reform.\textsuperscript{52} For example, in implementing changes in regulatory reform in support of protecting shareholders' rights, a country must also ensure that there is an underlying legal framework and discipline that will enforce such laws.\textsuperscript{53} Consequently, the costs of overriding an existing regulatory framework may outweigh the benefits derived from change.

Third, historical and cultural impediments may also prevent a change towards regulation protecting the rights of minority shareholders.\textsuperscript{54} In general, diversified shareholders value reasonable risks by managers because the diversification of their portfolios will ameliorate any potential downfall in value.\textsuperscript{55} As such, supporting cultural and political systems in countries like the United States and the United Kingdom support these interests by encouraging efficient market requirements on managers,
including incentive compensation and hostile takeovers. In contrast, social democratic countries, like France, are against "such elements of Schumpeterian 'creative destruction'." Rather, such cultures put an emphasis on protecting individual firms and minimizing dislocation costs of labor and other stakeholders, rather than taking on risks or growing at a faster rate. Thus, such cultural dissonance may impede a change towards regulation in favor of a dispersed ownership structure.

Despite these obstacles, countries have taken measures towards enhancing governance and disclosure standards in an effort, in substantial part, to stem the flow of firms cross-listing in other jurisdictions and to attract foreign firms to cross-list in their own country. A significant example is the actions taken by governments in Latin America in the past ten years to enhance the respective regulatory regimes of Argentina, Brazil, Chile, and Mexico in order to address the problem of firms choosing to cross-list in the United States. For example, in 2002 Mexico's National Commission on Banking and Securities, working with the Mexican Stock Exchange and the Mexican Association of Market Intermediaries, overhauled its rules on tender offers in favor of minority shareholders to give them a proportionate share of control in the event of takeover offers. Additionally, there has been the emergence of "high standards" markets established by exchanges in order to stop the migration of listings and trading in the United States.

For example, in December 2000, the São Paulo Stock Exchange (BOVESPA), Brazil's largest exchange, launched Novo Mercado, a new exchange based on the premise of high corporate governance where issuers

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56 Id.
57 Id. at 103 (quoting MARK J. ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE (Oxford University Press 2003)).
58 Id.
59 See also Licht, Legal Plug-Ins, supra note 46, at 199 (discussing how the implementation of western governance mechanisms in Korea conflict with Korea's Confucian heritage and values).
60 Coffee, supra note 1, at 1766.
61 See id. at 1766 n.24 (noting that Chile adopted a tender offer law in 2001; Argentina and Mexico adopted new capital markets laws in 2001; and Brazil adopted revised corporate governance standards in 2001 in order to enhance the rights of minority shareholders); see also Hargis, supra note 34, at 102 tbl.1 (finding that at the height of Latin American firms cross-listing in the United States in 1995, the combined value of Mexican, Argentine, and Chilean ADRs traded in the United States was greater than the total value of all stocks traded in their respective domestic markets during the year).
62 See Coffee, supra note 1, at 1810 ("Under this reform, non-voting shares now enjoy full "tag along" rights in the event of takeover offers. Specifically, the new rules preclude partial bids for just the controlling shares by requiring that if the bidder seeks to purchase between 30% and 50% of the voting stock, it must tender for all share classes on a similar basis and at the same price; further, any offer for more than 50% of the voting stock obligates the bidder to tender for 100% of all shares in all classes.").
63 Id. at 1804.
can only list by voluntarily electing to be subject to strict governance standards. During the 1990s, Brazil faced a dramatic decline in the number and overall value of shares listed on BOVESPA, as companies fled to the United States in order to “rent” the credibility and depth of a better regulated securities market. To address this exodus, Novo Mercado grants additional rights and guarantees to minority shareholders and, in exchange, firms listing on Novo Mercado agree to obligate themselves to:

(1) not issue non-voting shares and comply with a “one-share, one-vote rule”; (2) maintain a free float equivalent to 25% of the outstanding stock; (3) grant “tag along” rights under which all non-controlling shareholders would be accorded the same right to sell their shares on the same terms (including price) as were to be given to the controlling shareholders; and (4) elect all directors at each annual meeting.

Additionally, issuers must agree to stricter disclosure standards, including quarterly reporting with cash flow demonstration and consolidated statements audited by independent auditors and the use of either U.S. GAAP or IFRS for reporting purposes.

Novo Mercado is segmented into two different tiers (Level 1 and Level 2), thus giving investors three different listing segments between the traditional BOVESPA market and the two distinct tiers of the Novo Mercado. Level 1 requirements essentially resemble traditional Brazilian regulations with additional disclosure obligations but do not require enhanced corporate governance standards. Level 2 essentially requires that issuers comply with almost all of the disclosure and corporate governance requirements of Novo Mercado. In June 2001, fifteen companies listed on Level 1. By the end of 2001, nineteen companies listed on Level 1 (representing 19.13% of the exchange’s market capitalization and 14.39% of volume traded) and zero firms were listed on Level 2.

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64 Maria Helena Santana et al., Focus 5: Novo Mercado and Its Followers: Case Studies in Corporate Governance Reform, Global Corp. Governance Forum, Nov. 2007, at 1, available at http://www.gccf.org/ifcext/cgf.nsf/AttachmentsByTitle/Focus%205/$File/Novo+Mercado+text+screen+4-21-08.pdf.
65 Id. at 2–9.
66 Coffee, supra note 1, at 1807.
67 Santana, supra note 64, at 14.
68 Id. at 13.
69 Id.
70 See id. (noting that companies may keep their preferred shares but must assign “tag-along rights of 80[%] of the price at which control is sold, as well as the right to vote in certain important situations”).
71 Id. at 22.
By the end of 2005, forty-six companies listed on Novo Mercado, thirty-six on Level 1 and ten on Level 2. By the end of 2007, 156 companies were listed on Novo Mercado (Levels 1 and 2), representing 57% of BOVESPA's total market capitalization, 66% of the trading volume, and 74% of the number of trades in the cash market. In effect, Novo Mercado is demonstrating Brazil's ability to attract capital and stem the flow of financial migration to the United States by offering a stronger disclosure and corporate governance regime similar to that found in the United States.

In summary, cross-listing firms seeking regulatory regimes that afford greater protection for minority shareholders' rights are impacting the regulation in their home countries. Although these firms may face obstacles to change, evidence shows that cross-listing is, in some markets, leading to converging standards that stress high disclosure and corporate governance. This competition benefits cross-listing firms by offering more attractive markets to issue shares, potentially lowering their cost of capital.

C. Target Country Characteristics

In addition to affecting home country regulatory regimes, cross-listing also affects, to some extent, the regulatory regimes of the target countries in which firms choose to list their shares. More specifically, although cross-listing firms do not have a political voice in the target countries, they do influence regulatory decisions because of the threat posed by such firms choosing to cross-list somewhere else or not cross-list at all. Consequently, target countries may offer concessions and exemptions to foreign issuers in situations where the contemplated benefit of cross-listing may be outweighed by the perceived cost of cross-listing. The United

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72 Id.
73 Santana, supra note 64, at 23.
74 Id. at 24.
75 See, e.g., Alexander Ragir, Around the Markets: Tough Rules Draw Funds to Brazil, INT'L HERALD TRIB., Mar. 8, 2007 (“Brazil is attracting overseas investors by playing their game. The Novo Mercado, a new stock market whose corporate governance rules mirror those of the United States and Europe, almost doubled its listings in 2006.”).
76 See supra notes 44–59 and accompanying text.
77 But see Coffee, supra note 1, at 1814–17 (arguing that the effects of cross-listing may, in fact, lead to the specialization of markets between “high disclosure” markets protecting minority shareholder interests and “low disclosure” markets protecting the interests of incumbent, controlling shareholder firms resistant to change). Coffee describes this as a compromise between the “race to the top” scenario and the “race to the bottom” scenario. Id.
78 Ribstein, supra note 7, at 119.
79 Id.
80 Id. at 120.
States, representing the most attractive market for cross-listing firms, provides a prime example.

Foreign issuers in the United States trade through ADRs at four different levels. Level I trades of ADRs are executed through over-the-counter markets and are exempt from issuer registration under Rule 12g3-2. Level II and III ADRs, which trade on a securities exchange, Nasdaq, or OTC-BB, are required to register under Section 12 of the Exchange Act. However, such issuers are provided the benefit of filing one annual report, Form 20-F, instead of the additional periodic disclosures required of U.S. issuers. Form 20-F provides additional accommodations including a longer filing deadline and less restrictive disclosure requirements. Level IV ADRs trade on an exchange called "PORTAL," and are exempt from U.S. reporting standards under Rule 144A of the Securities Act because they are traded solely among Qualified Institutional Buyers ("QIBs").

An additional accommodation is the exemption of foreign issuers from the proxy rules and the liability rules associated with the short-swing profits

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81 See supra note 3 (defining American Depositary Receipts).
82 See 17 C.F.R. § 240.12g3-2(b) (2008) (exempting non-listed foreign private issuers ("FPIs") from registration and reporting under the 1934 Act if they furnish disclosure documents filed under their home country laws or if held by fewer than 300 U.S. residents at the end of the firm’s fiscal year). In 2008, the SEC adopted rules amending Rule 12g3-2(b), including: (1) eliminating the paper submission requirement, (2) allowing the exemption if the average daily trading volume of the FPI is no greater than 20% of the average daily trading volume of that class worldwide, (3) requiring the FPI to maintain a listing of the subject class of securities traded in the United States on one or more foreign exchanges, (4) requiring the FPI to publish in English specified non-U.S. disclosure documents on its website, and (5) requiring that the FPI not have any reporting obligations under the Exchange Act Section 13(a) or 15(d). Securities Act Release No. 34-58465, 73 Fed. Reg. 57252 (Sept. 10, 2008). A "foreign private issuer" is defined as:

[Al]ny foreign issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50% of the outstanding voting securities of such issuer are held of record either directly or through voting trust certificates or depositary receipts by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50% of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.

17 C.F.R. § 240.3b-4(c) (2008).
83 17 C.F.R. § 240.12g-1 (2008).
85 Form 20-F Adopting Release, supra note 84.
86 17 C.F.R. § 230.144A (2008). A QIB, among other things, must own at least $100 million in securities of issuers that are not affiliated with the entity. 17 C.F.R. § 230.144A(a)(i).
provisions of the Securities Act and the Exchange Act. Also, under Rule 15a-6 of the Exchange Act, foreign brokers and dealers are exempt from the registration requirements of Sections 15(a)(1) and 15B(a)(1) of the Exchange Act if certain prerequisites are satisfied. Furthermore, U.S. exchanges, including the NYSE and Nasdaq, have effectively exempted foreign issuers from important regulatory provisions, including certain independent audit committee obligations, shareholder approval of certain stock option plans, and shareholder approval of the issuance of 20% or more of a listed company’s common stock used to protect shareholders against dilutive issuances. Although these provisions are intended to protect minority shareholders, the Securities and Exchange Commission (“SEC” or “Commission”) has, to a great extent, approved of such disparity. However, such accommodations impede the efforts of the home countries of cross-listing firms to improve their regulatory regimes and call into question the benefits attributed to the bonding theory.

Specifically, when foreign markets, like Novo Mercado, seek to upgrade their governance standards, they face the problem that the firms they seek to attract have the option to by-pass such exchanges by listing in the United States and obtaining greater liquidity at a lower governance threshold. In effect,

[the unwillingness of U.S. exchanges to impose governance or voting listing requirements on foreign listed firms thus surfaces as a barrier to improved governance in emerging markets; indeed, it may create a perverse form of regulatory competition in which U.S. exchanges in effect underbid their competitors in terms of substantive governance requirements.]

Such exemptions represent a disservice to the potential investors that cross-listing firms seek under the bonding theory because, in the absence of strong requirements, such investors may not be able to discern high quality firms from low quality firms. Yet, the argument remains that firms will not

87 17 C.F.R. § 240.3a12-3(b) (2008).
89 Coffee, supra note 1, at 1821-22.
90 Id. at 1822; see also Exchange Act Release No. 7053 [1993-1994 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 85, 203-04 (Apr. 19, 1994) (arguing accommodations to foreign issuers as “part of [its] ongoing efforts . . . to ease the transition of foreign companies into the U.S. disclosure system, enhance the efficiencies of the registration and reporting process and lower costs of compliance, where consistent with investor protection”).
91 Coffee, supra note 1, at 1821.
92 Id.; see also id. at 1768 (“[A]lthough some [foreign] markets have actually leapfrogged the United States in terms of the governance and disclosure standards that the United States now mandates for foreign issuers, they have encountered a ceiling on their ability to upgrade standards because of the laissez-faire attitude of U.S. exchanges toward foreign issuers.”).
cross-list if the cost of bonding exceeds the benefits of cross-listing. The solution to this predicament lies in the convergence of high-quality disclosure and governance standards that would equalize the cost of compliance across jurisdictions while still maintaining the benefits firms seek under the bonding theory.

III. THE EFFECT OF IFRS ON CROSS-LISTING UNDER THE BONDING THEORY

The acceptance and convergence of International Financial Reporting Standards ("IFRS") provides a solution to the disconnect between balancing the costs associated with cross-listing and the benefits sought under the bonding theory. Specifically, the convergence of IFRS across jurisdictions would decrease the cost of compliance for firms choosing to cross-list while still providing a high-quality reporting regime to potential investors.

The adoption of IFRS and push towards international convergence has been at the forefront of debate among international regulatory institutions, including the International Accounting Standards Board ("IASB"), the SEC, and the International Organization of Securities Commissions ("IOSCO"), among others. The origins of IFRS date back to 1973 with the establishment of the International Accounting Standards Committee ("IASC"), which was formed to begin the creation of a comprehensive set of international standards favorable to national securities regulators. The IASC began as a part-time standards setter and made relatively modest efforts in developing a core set of standards that were presented to securities regulators in 1998. However, in 2000, the IOSCO failed to endorse the standards presented which, in turn, led to the transition of the IASC into the IASB.

The IASB implemented changes, including the adoption of a new

93 Ribstein, supra note 7, at 120.
94 See Daske, supra note 24, at 4–5 (finding that the mandatory adoption of IFRS decreased the cost of capital and increased liquidity for firms in countries where firms have an incentive to be transparent and where legal enforcement is strong).
95 The IASB is a worldwide institute with the goal of bringing about convergence of accounting standards. IASB, General Information about IASB, available at http://www.iasb.org/The+organisation/IASCF+and+IASB.htm (last visited Mar. 8, 2010).
96 IOSCO consists of securities regulators from 189 countries (consisting of ordinary, associate, and affiliate members) who are committed to working together to "promote high standards of regulation in order to maintain just, efficient and sound markets." IOSCO, General Information about IOSCO, http://www.iosco.org/about/ (last visited Mar. 8, 2010).
99 Id. at 591–92.
100 Id. at 592.
constituent that created a board designated to build upon and issue interpretations about IFRS. Central to the IASB's efforts is the concept of convergence, with a goal "to identify the best in standards around the world and build a body of accounting standards that constitute the 'highest common denominator' of financial reporting." Since its inception, the IASB's efforts have accelerated towards convergence of IFRS. However, success without U.S. participation would be incomplete and, as U.S. capital markets are the deepest and most liquid in the world, would fail to capture the full benefits that international reporting standards could offer. Thus, the IASB has been working with the U.S. Financial Accounting Standards Board ("FASB") since 2002 in an effort towards eventual financial reporting standards convergence.

In 2005, the European Union adopted a regulation that requires all publicly traded companies to use IFRS for their consolidated accounts beginning January 2005. Countries across the world have quickly followed suit, with over 100 countries requiring or allowing the use of IFRS for reporting purposes. Recently, the United States took two important steps towards the adoption of IFRS. First, in December 2007, the SEC adopted rules permitting foreign private issuers to file financial statements with the Commission that comply with IFRS, as issued by IASB, without reconciliation to U.S. GAAP. Second, in November 2008, the SEC proposed a roadmap for U.S. issuers to switch over to IFRS by 2014.

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102 Tweedie, supra note 98, at 592 (citing INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE, IASC FOUNDATION CONSTITUTION 5 (2002)).

103 Id.

104 See id. at 594 (noting that U.S. capital markets accounted for 46% of the world's market capitalization in 2003, compared to the combined market capitalization of the European Union at 25.3%).


106 See Tweedie, supra note 98, at 597-98 (describing the initial agreement between the FASB and the IASB (the "Norwalk Agreement") in 2002 along with subsequent efforts).


The trend towards adoption of IFRS has important implications both for investors and cross-listing firms in the context of the bonding theory.

A. Benefits to Investors

Under the bonding theory, firms cross-list in order to utilize stricter disclosure obligations and governance standards to bond their promise with potential investors that they will protect minority shareholder rights. Therefore, firms looking to establish that bond will not support IFRS unless it provides sufficient regulation and disclosure. The majority of concerns surrounding the adoption of IFRS are related to whether the standards can afford protection at a similar level to U.S. GAAP. However, two observations challenge this notion.

First, U.S. GAAP's thorough accounting standards have failed to prevent recent widespread accounting standards, including the Enron and WorldCom debacles. Lessons from Enron have shown that under U.S. GAAP, firms may potentially be able to play "regulatory arbitrage" by structuring inappropriate transactions that may comply with bright-line tests as specified under U.S. GAAP. This is the strategy Enron employed by using Special Purpose Entities ("SPEs") to record amounts off their books while, in effect, materially overstating earnings.

Second, in the wake of such scandals, the SEC has conducted a study of U.S. GAAP's rule-based approach and has identified its potential shortcomings. Three of the most significant shortcomings with rule-
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Based standards identified by the SEC are that they:

Contain numerous bright-line tests, which ultimately can be misused by financial engineers as a roadmap to comply with the letter but not the spirit of the standards; Contain numerous exceptions to the principles purportedly underlying the standards, resulting in inconsistencies in accounting treatment of transactions and events with similar economic substance; and Further a need and demand for voluminously detailed implication guidance on the application of the standard, creating complexity in and uncertainty about the application of the standard.\(^\text{117}\)

Thus, the SEC concluded that a principle-based accounting system provides benefits not offered under a rule-based accounting system.\(^\text{118}\)

Additionally, the IASB has demonstrated a willingness to incorporate beneficial provisions of U.S. GAAP into IFRS, and IFRS has met the criteria set forth by the SEC for adoption.\(^\text{119}\) For example, since the Norwalk Agreement in 2002, the FASB and the IASB have been carrying out “joint projects” to reduce differences regarding issues such as revenue recognition, business combinations, and to build a common conceptual basis between IFRS and U.S. GAAP.\(^\text{120}\) IFRS has also satisfied criteria set forth by the SEC for the adoption of international standards, including: (1) the inclusion of a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting, (2) high-quality standards based on comparability and transparency, and (3) standards that are rigorously interpreted and applied.\(^\text{121}\)

As such, the provisions of IFRS have demonstrated high-level disclosure requirements that complement the transparency demanded by investors under the bonding theory. Additionally, the adoption of a principle-based standard arguably shows that countries, including the United States, want an accounting standard that is “investor-centered rather than accountant-centered.”\(^\text{122}\) By reducing the complexity of financial standards of financial reporting established on a rule-based basis and standards established on a principles-only basis).

\(^{117}\) Id.

\(^{118}\) Id.

\(^{119}\) Hanson, supra note 101, at 543–54.

\(^{120}\) Id. at 546–47. For example, one difference between IFRS and U.S. GAAP concerned the issue of when a corporation could engage in “uniting of interests or pooling accounting for a merger or acquisition.” Id. at 547. Convergence efforts have now eliminated this difference under both IFRS and U.S. GAAP by prohibiting uniting of interests in favor of just the acquisition treatment. Id.


\(^{122}\) See id. at 555 (arguing that IFRS “improve[s] investors’ access to information for making investment decisions” while “reduce[ing] the complexity of financial statements and
disclosure, auditors, in turn, will have an easier time testing financials and asking direct questions about a company's accounting treatment.\textsuperscript{123}

Furthermore, with the adoption of IFRS, investors face benefits including: (1) more accurate, thorough, and timely financial statements in comparison to national standards in other countries, (2) the reduction of adverse selection between minority investors and professionals, (3) a reduction in the cost to investors of analysts processing multiple reporting standards, (4) a resulting increase in the efficiency with which the stock market incorporates processed financial information in stock prices, and (5) a reduction in barriers to cross-border acquisitions and divestitures, which, in theory, will reward investors with increased takeover premiums.\textsuperscript{124} In total, these benefits make IFRS an attractive standard for firms looking to lure investors by cross-listing under the bonding theory.

B. Benefits to Cross-listing Firms

From the perspective of cross-listing firms, the adoption of IFRS and the push towards international convergence provides additional benefits under the bonding theory. The primary advantage is economies of scale: firms choosing to cross-list do not have to incur the compliance costs of reconciling financials to different reporting standards (absent an exemption) when issuing shares abroad.\textsuperscript{125} Additionally, IFRS eliminates informational externalities that may arise from a lack of comparability between different sets of financial reporting standards.\textsuperscript{126} In other words, when countries impose different accounting standards, firms incur additional costs due to lack of comparability of financial information even if such differences are disclosed to investors.\textsuperscript{127} Thus, in the context of the bonding theory, IFRS allows firms to cross-list shares using a high-standard disclosure system and avoid additional costs of compliance while still signaling to potential investors a bond towards transparency and protection of minority shareholders' rights.\textsuperscript{128}

In summary, IFRS provides the high-level disclosure requirements that

\textsuperscript{enhanc[ing] transparency.").

\textsuperscript{123} Id. See also Ray Ball, International Financial Reporting Standards (IFRS): Pros and Cons for Investors, 36 ACCT. & BUS. RES. 5, 7, available at http://www.abr-journal.com/pdf/005-028.pdf (“The . . . advantage of uniform standards is the protection they give auditors against managers playing an ‘opinion shopping’ game. If all auditors are required to enforce the same rules, managers cannot threaten to shop for an auditor who will give an unqualified opinion on a more favourable rule.").

\textsuperscript{124} Ball, supra note 123 (manuscript at 15–16).

\textsuperscript{125} Id. (manuscript at 6).

\textsuperscript{126} Id. (manuscript at 7).

\textsuperscript{127} See id. (“To the extent that firms internalize these effects, it will be advantageous for them to use the same standards as others.").

\textsuperscript{128} Recent data has confirmed this notion. See Daske et al., supra note 25, and accompanying text.
investors seek while reducing the costs cross-listing firms may face when looking to issue shares abroad. Thus, IFRS equalizes the cost of compliance across jurisdictions while still maintaining the benefits to firms attributed to the bonding theory.

IV. IMPEDIMENTS TO THE CONVERGENCE OF CORPORATE GOVERNANCE STANDARDS

The convergence of corporate governance standards across jurisdictions may provide similar benefits as those provided by IFRS to cross-listing firms. However, a push towards the convergence of corporate governance standards poses a much more difficult scenario in contrast to the convergence of disclosure standards, such as IFRS. More specifically, deep-seated political and cultural differences across jurisdictions create an impediment towards corporate governance convergence. The enactment of the Sarbanes-Oxley Act of 2002 ("SOX") and resulting foreign issuer response illustrates this predicament.

In general, SOX requires companies to upgrade their disclosure and governance in a number of ways, including:

- regulation of firms providing audits for companies publicly traded in the U.S.;
- requirement of independent audit committees;
- certification of financial statement accuracy and internal controls by executive and financial officers;
- executive reimbursement of incentive compensation from any accounting period for which earnings had to be restated;
- lawyers' duty to report evidence of securities violations;
- prohibition of issuer loans to executive officers or directors;
- annual report disclosures of managers' responsibilities for setting up internal control and financial reporting structure and procedures;
- disclosures regarding an issuer's code of ethics, disclosures regarding the audit committee's "financial expert"; and
- whistle-blower protection.

However, SOX has created many new problems for foreign based firms cross-listing in the United States. For example, SOX prohibits loans to executives, while German law simply restricts similar loans in larger

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129 Ribstein, supra note 7, at 120.
130 Id. at 98.
132 See Ribstein, supra note 7, at 124–29 (discussing the impact of the Sarbanes-Oxley Act on the cross-listing market); Coffee, supra note 1, at 1824–27 (describing the responses of foreign issuers to SOX).
133 Ribstein, supra note 7, at 125.
134 See Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C. § 78m(k)(1) (2006) ("It shall be unlawful for any issuer . . . to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer . . . of that issuer.").
public companies unless they are approved by the supervisory board.\textsuperscript{135} Additionally, SOX’s independent audit committee requirement represents a revolutionary reform for companies incorporated under civil law regimes, where there is often a requirement of a two-tier board, “with the lower or ‘managing board’ having no independent directors and the upper or ‘supervisory board’ being half composed of representatives of employees.”\textsuperscript{136} Consequently, because codetermination laws result in supervisory boards consisting of employee and union representatives, “civil law corporations have generally resisted giving the supervisory board significant substantive responsibilities.”\textsuperscript{137} This is in direct conflict with SOX, which assigns to the audit committee all responsibility “for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting).”\textsuperscript{138}

Another example of where SOX conflicts with foreign governance standards involves SOX’s oversight of corporate executives.\textsuperscript{139} Under U.S. law, executives wield significant power, subject only to oversight by the company’s board.\textsuperscript{140} So, it is reasonable to regulate potential conflicts of interest that may arise between executives and shareholders.\textsuperscript{141} However, in many other countries, corporate hierarchies may be structured differently so that executives have less power.\textsuperscript{142} This is the case in Japan, where Japanese corporations do not have executive officers as conceived under SOX regulations, but are run by a complex hierarchy of committees.\textsuperscript{143} These examples illustrate the significant corporate governance differences that arise across jurisdictions.

The SEC, in response to such differences and out of a concern that foreign firms would stop cross-listing in the United States, created several exemptions for foreign issuers under SOX. For example, the SEC permits foreign private issuers to comply with the requirement to include in their annual reports management’s report on the company’s internal control over

\textsuperscript{135} Ribstein, \textit{supra} note 7, at 125.
\textsuperscript{136} Coffee, \textit{supra} note 1, at 1825.
\textsuperscript{137} Id.
\textsuperscript{139} Ribstein, \textit{supra} note 7, at 126.
\textsuperscript{140} Id.
\textsuperscript{141} Id.
\textsuperscript{142} Id.
\textsuperscript{143} See id. at 126–27. (‘‘This suggests potential difficulty in applying Sarbanes-Oxley provisions dealing with executive certification of financial reporting and monitoring devises. It also raises questions about applying Sarbanes-Oxley’s prohibitions on trading during restrictions on pension plans participants, and various provisions imposing liability on executives.’’).
financial reporting and the auditor’s attestation on a delayed basis compared to U.S. issuers. Also, foreign private issuers are permitted to report changes in their internal controls over financial reporting on an annual basis, rather than on a quarterly basis as is required of domestic issuers. Additionally, with respect to the audit committee independence requirements, foreign private issuers listed on U.S. exchanges are accorded certain accommodations that recognize non-U.S. practices and requirements.

The illustration of how SOX affects foreign issuers looking to cross-list provides significant insight under the bonding theory. Most importantly, the example demonstrates that deep-seated differences in corporate governance laws pose a significant impediment to the convergence of corporate governance standards. As such, the goal of international regulatory regimes and the IOSCO should be towards identifying how to maintain high-quality corporate governance standards while still accommodating underlying political and cultural differences.

V. CONCLUSION

Over the past twenty years there has been an observable worldwide growth in stock market capitalization. Additionally, more and more companies are choosing to cross-list their shares in markets abroad in order to raise equity at a lower cost of capital. The bonding theory postulates that cross-listing on an exchange in a market that has strong investor protection commits the listing firm to recognize minority shareholders’ rights and to increase transparency in disclosures. In doing so, a firm is able to increase shareholder confidence, which in turn reduces the discount potential investors place on the firm’s shares and leads to a reduction in the cost of capital.

However, where the cost of compliance seemingly outweighs the perceived benefit of cross-listing, some foreign firms will avoid cross-listing. In response, target countries may provide exemptions to regulatory requirements in order to entice foreign firms to cross-list. This arguably has a contrarian effect to the bonding theory as it dilutes the bond or assurance cross-listing firms send to investors regarding the protection afforded by the target country’s regulatory regime. Thus, there is an overall benefit created by the convergence in high-quality regulatory standards in that it equalizes the cost of compliance across jurisdictions while still maintaining the benefits to firms attributed to the bonding theory.

As a solution to this problem, the convergence of disclosure requirements provided by IFRS gives the high-level disclosure requirements that investors seek while reducing the costs cross-listing firms may face when issuing shares abroad. Thus, IFRS equalizes the cost of compliance across jurisdictions while still maintaining the benefits to firms attributed to the bonding theory. The convergence of corporate governance standards may also provide the same benefit, but deep-seated political and cultural differences make it difficult to achieve such convergence.

Therefore, the goal of international regulatory regimes and the IOSCO should be towards promoting IFRS and identifying how to maintain high-quality corporate governance standards while still accommodating underlying political and cultural differences.