PRIVATE SECURITIES LITIGATIONS AGAINST FOREIGN FIRMS

EMPIRICAL FINDINGS

Master of Arts in Law and Diplomacy Thesis

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1 Introduction

Corporate governance and lack of effective legal protection for minority shareholders have become prominent subjects all over the world after scandals such as Enron/Arthur Andersen in the U.S. and Parmalat in the European Union. Historically, the United States has been praised for having the most rigorous and comprehensive securities regulation. As the number of foreign firms cross-listing on US stock exchanges has dramatically increased during the last decade, many academics have tried to find the reasons behind the decisions to cross-list. One of the most discussed reasons is the 'bonding hypothesis' according to which foreign firms cross-list on US stock exchanges in order to leapfrog their home countries' weak legal institutions by agreeing to abide by US securities regulations.

According to the bonding hypothesis, cross-listing on a foreign stock market can serve as a bonding mechanism for corporate insiders to commit credibly to a better governance regime and to increase protection of their minority shareholders. The main arguments for the bonding hypothesis are presented by Coffee (1999), who argues that by cross-listing their securities in the US, a foreign firm wishes to signal adherence to generally higher standards of corporate governance than is required domestically. Consequently, the firm's market value increases and its cost of capital falls. The bonding hypothesis is criticized by several academics mainly for two reasons. First, foreign firms are bound to a different, and arguably to a less stringent securities regulation regime. Second, the Securities Exchange Commission is criticized for insufficient enforcement of its rules on foreign issuers. However, most of these studies have disregarded private securities litigation as a way to enforce bonding with the US regulatory regime.

This paper is an exploratory study that aims to present an overview of the academic discussion relating to the bonding hypothesis and to constructively reflect on the critique against it. It also endeavors to reconcile one of the main theories concerning MNEs – the theory of liability of foreignness – with the discussion about cross-listing and the bonding hypothesis. The last part of the paper is an empirical analysis of an extensive dataset on private securities lawsuits against foreign and domestic firms between 1996 and 2002. The aim of the empirical section is twofold. First, it aims to reflect the results of prior research done on the bonding hypothesis in the light of this dataset. Second, it will examine whether private securities cases are serving as a mechanism for foreign firms to bond with a higher corporate governance regime, or whether the foreign firms are treated differently with respect to the private securities cases -- in other words, do they bear a liability of foreignness? My hypothesis is that private securities cases force foreign firms to bond to the US securities regime. As a result, I expect to find that foreign firms are treated similarly to domestic firms with respect to private securities cases. Foreign firms which have recently cross-listed on a US stock exchange are at a disadvantage due to the liability of foreignness and thus the probability that they are sued is higher than for domestic firms or foreign firms familiar with the US regulations.

The paper is structured as follows. First, I will examine the theoretical issues and context relevant to the study, including motivations to cross-list, bonding hypothesis, and the legal liability of foreignness. I will then introduce the U.S. securities law regime, its extraterritorial reach and different enforcement mechanisms used to enforce the securities law. I rationalize why private securities litigations might be the most important way to enforce the minority shareholder rights. In the empirical part, I present the dataset and its

variables. I also present the results and analyze them in the light of the theoretical part of the paper. Finally, I conclude the paper.

2 Theoretical Framework

2.1 Cross-Listing[1] on the U.S. Exchanges

Since the 1990s, the number of foreign firms listed on the NASDAQ, NYSE and Amex grew from 170 in 1990 to over 970 in 2001 [2]. The impact of cross-listing has been particularly pronounced on the NYSE, and foreign listings on it have grown from approximately 2% of all NYSE listings in 1975 to over 17% in 2002[3]. The sharp increase in foreign firms cross-listing on the U.S. exchanges has been a serious focus of interest to researchers, which have both examined the impact of a company's decisions to list its shares abroad and to understand the reasons behind decisions to cross-list. This question has become even more prominent as foreign issuers incur extensive regulatory costs when entering the U.S. markets. In spite of these costs, most of them never thereafter make securities offerings in the United States[4].

In addition to the legal considerations for firms to cross-list in the U.S., there are several other reasons why a firm would choose to cross-list outside their home country. Generally, the main benefits of cross-listing occur when international capital markets are small or segmented[5]. By cross-listing and selling its shares on a foreign stock exchange, a

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[1] Cross-listing may be defined as an additional listing by a firm on a stock exchange outside the home country or to less common situation where a firm by-passes its home market altogether and lists abroad.. See B. Schrage and P. Vaaler: "Home Country Corporate Governance and the Bonding Hypothesis: Evidence form Emerging-Markets" Working Paper 2003.

[2] Ibid.

[3] See New York Stock Exchange Website, www.nyse.com

[4] John C. Coffee. "The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications". *Northeastern University Law Review* Vol 93, No. 3, 673.

[5] According to Eiteman et al (2001): 'a national capital market is segmented if the required rate of return on securities in that market differs from the required rate of return on securities of comparable expected return and risk that are traded on other national securities market'. Market segmentation occurs because of investment

firm typically tries to accomplish several objectives, such as to lower the cost of capital, and to increase stock liquidity, firm visibility and shareholder base. Decision on where to cross-list and raise equity depends largely on these motivations and the country of origin[6]. There are a number of additional direct and indirect costs to cross-listing, such as additional reporting requirements, registration costs and listing fees, expected costs of material time, underwriting and professional fees, and potential legal liability that occurs when cross-listing. As a result, the advantages of cross-listing need to override the costs.

Lower Cost of Capital. The earliest cross-listing study – led by Andrei Karolyi – concentrates on motivations to lower the cost of capital by diversification gains and segmentation gains[7]. In a country where the domestic capital market is segmented, firms face a higher cost of capital as the risk is borne by the investors from this country. By allowing foreign investors to invest and by accessing international capital markets, the cost of capital is lowered by diversification and risk sharing.[8] Thus, the stock price will increase in the home country, and the cost of capital of the company declines in response to the cross-listing as mispricing in a segmented and illiquid home capital market is overcome. Recent studies done by Alexander et al. (1997), Foester and Karolyi (1999), and Errunza and Miller

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barriers, e.g. taxes, regulatory restrictions or informational constraints. Eiteman et Al. *Multinational Business Finance*. 9th Edition. Addison Wesley Longman, Singapore, 2001, 304.

[6] According to Amir Licht, for example, Israeli firms often list on the U.S. stock exchanges because in 2000 the Israeli Parliament made it easier to list on Tel Aviv Stock Exchange based on voluntary disclosures or disclosures they make under U.S. Law. Jackson and Pan found that the main reason of European issuers is financial considerations, followed by prestige. See Howell E. Jackson & Erik Pan. "Regulatory Competition in International Securities Markets: Evidence from Europe in 1999 – part II" (unpublished, forthcoming Business Law).

[7] Karolyi, G "Why do Firms List Shares Abroad? A Survey of the Evidence and Its Managerial Implications". *Financial Markets, Institutions and Instruments*. Vol 7, BlackIll, Boston, 1998.

[8] Errunza, V. & D. P. Miller "Market Segmentation and the Cost of Capital in International Equity Markets", *Journal of Financial and Quantitative Analysis* Vol. 35 No. 4 Dec 2000. See also: Leuz, Christian "Discussion of ADRs, Analysts, Accuracy: Does Cross Listing in the U.S. Improve a Firm's Information Environment and Increase Market Value?", Working Paper 2002, 4.

(2000) have found that the cost of capital declines after the cross-listing, consistent with the market segmentation hypothesis.

Increasing Stock Liquidity. Cross-listing may be driven by the fact that it contributes to share value by increasing stock liquidity and decreasing transaction costs. Firms domiciled in countries with small illiquid capital markets often outgrow these markets, and are forced to raise new equity abroad. The liquidity is best improved by cross-listing and issuing equity in a prestigious market, and eventually being able to offer a global equity issue[9]. Access to more investors might lead to higher volume and information asymmetries could decrease due to increased disclosure. Foester and Karolyi (1998) find that spreads decrease and trading volume increases following a cross-listing, both of which will likely reflect an increase in liquidity. Coffee (2002) argued that emerging market firms tend to be interested in raising equity capital from the U.S.

Firm Visibility and Increased Shareholder Base. Cross-listing seems to improve firm visibility to U.S. investors and consumers, which has the advantage of broadening the company's shareholder base, which in turn may lead to a lower cost of capital. The shareholder base of the company may increase due to the simple fact that many U.S. institutional investors are prohibited from investing in foreign firms that are not listed on U.S. exchanges. Firms with cross-listings in the U.S. exhibit higher analyst following and forecast accuracy. According to Roell (1995), enhanced visibility is usually cited as the first or second most important motivation for the decision to go public[10].

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[9] Karolyi, G. and Stephen Foester. "International Listings of Stocks: The Case of Canada and the U.S." 24 *J. Int'l Business Studies* 763, 772-773, 1993. Karolyi and Foester studied 53 Canadian firms cross-listing on a U.S. stock exchange during 1981-1990. They found there was a significant increase in stock liquidity of the newly cross-listed stocks that are reflected in increased trading volume on Toronto and U.S. stock exchanges.

[10] Roell, A. "The decision to Go Public: An Overview", LSE Financial Group Discussion Paper, No 225, 1995.

Marketing Motivations. Some firms may cross-list for marketing reasons. According to Saudagaran (1998), a foreign listing may boost corporate marketing efforts by enhancing name recognition among investors and consumers in the foreign country. Also, reports written by local analysts and reporters are often seen as free advertising[11]. For large firms located in small markets, foreign sales are crucial and hence cross-listing might be a very good promotional tool for them. According to Perotti and Cordfunke (1997), Dutch firms have long followed this strategy: For example, KLM sold 15 millions shares in 1986, 40% across Europe, 55% in the U.S. and the rest in Japan, in order to promote its international activities and support the share price[12].

Technical Issues. Finally, there are some technical issues that might serve as reason to cross-list. Cross-listing may improve a firm's ability to effect structural transactions abroad as foreign mergers and acquisitions, stock swaps, and tender offers. Some firms may want to obtain an "acquisition currency" – that is a medium of payment for making future acquisitions of firms located in the country. Belatedly, cross-listing also boosts the attractiveness of employee stock ownership plans ("ESOPs") for employees of large multinational corporations. Hence, a company may want to create a secondary market for shares that can be used to compensate local management and employees in foreign affiliates[13]. Coffee (2002) argued that firms from the European countries often cross-list in the U.S. for these technical reasons and to gain a currency with which they can make stock-

[11] Saudagaran, S. "An Empirical Study of Selected Factors Influencing the Decision to List on Foreign Stock Exchanges", *Journal of International Business Studies*, Spring 1988, p. 101-127.

[12] Perotti, E. & Egbert Cordfunke "Do Foreign Cross-Listing Increase Firm Value? Evidence from Announcement Effects of Dutch Firms", September 1997.

[13] Saudagaran, S. "An Empirical Study of Selected Factors Influencing the Decision to List on Foreign Stock Exchanges", *Journal of International Business Studies*, Spring 1988, p. 101-127.

for-stock acquisitions of U.S. firms[14].

Bonding Hypothesis. According to the bonding hypothesis, cross-listing on a foreign stock market can serve as a bonding mechanism for corporate insiders to commit credibly to a better corporate governance regime[15] and to increase protection of their minority shareholders. Roe argues that corporate governance is a sum of cultural and economic factors in each country, and thus the corporate governance regimes are unique in each country. The corporate governance regime of the U.S. is an outcome of "strong managers, weak owners". In contrast to other countries, the populist move in the U.S. helped to maintain a fragmentation of financial institutions and a separation from commercial enterprises. In order to solve the problem of management power over dispersed shareholders – the classic principal-agent problem – the U.S. Congress has developed a much stricter and comprehensive securities regulation regime than other countries with a different company structure.[16]

The main arguments on the bonding hypothesis are introduced by Coffee (1999), according to whom U.S. disclosure requirements, exposure to SEC enforcement, and shareholder litigation decrease the principal-agency problem. Controlling owners and managers no longer can extract private benefits from outside investors and minority shareholders. Thus, bonding with the US laws and regulations increases the expected costs to managers of extracting private benefits, and commits the firm to protect minority

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[14] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002

[15] Mark J. Roe describes corporate governance as "the relationship among a firm's shareholders, its board of directors and its senior manageers". In foreign countries, there may be other additional constituencies involved in it. See Mark J Roe. "A Political Theory of American Corporate Finance". *Columbia Law Review* 10 (1991).

[16] Ibid

shareholders' interests[17]. By cross-listing their securities in the US, a foreign firm wishes to signal adherence to higher standards of corporate governance than are required domestically.

2.2 Prior Research on Bonding Hypothesis

The term bonding is a term of art in modern institutional law and economics. The term was invented by Jensen & Meckling (1976), and they defined it as "costs or liabilities that an agent or entrepreneur will incure to assure investors that it will perform as promised, thereby enabling it to market its securities at a higher price"[18]. The earliest studies using stock exchange listing as a mechanism for bonding to a better governance regime were published in 1988 by Jeffrey Gordon in a fully domestic context. Gordon presented the bonding hypothesis with regard to listings on the NYSE, and argued that insiders of the firms wishing to lower the cost of capital wanted to bond a promise that the firm's single class capital structure will not be renegotiated[19]. Coffee (1999) extended this hypothesis to concern foreign firms by arguing that foreign legal systems lead bonding firms' insiders to better governance and hence for lowering agency costs. Moreover, Coffee argued that as foreign issuers migrate to list in the US markets, and so become subject to US standards, the relative importance of variations between the corporate laws and corporate governance of different countries should decline.

[17] William A. Reese Jr. & M. Weisbach. "Protection of Minority Shareholder Interests, Cross-Listings in the United States and Subsequent Equity Offerings". *Journal of Financial Economics* 66 (2002): 65-104.

[18] Jensen & Meckling. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. 3 *Journal of Financial Economics* 305 (1976).

[19] Gordon, J. "Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice" 76. *California Law Review* 3 (1988).

Coffee (2002) lists three different mechanisms in his most recent study, by which listing on a U.S. exchange commits the listing firm to respect minority investors rights, thus to bond with the higher corporate governance regime:

1. The listing firm becomes the subject to the enforcement powers of the SEC
2. Investors acquire the ability to exercise effective and low-cost legal remedies (such as class action and the derivative action) that are not available in the firm's home jurisdiction.
3. The entry into the U.S. markets commits the firm to provide fuller financial information and to reconcile its financial statements to U.S. GAAP accounting principles[20].

The empirical evidence of bonding hypothesis is still scarce. Miller's study (1999) on firms that had already overcome the problem of market segmentation by cross-listing on OTC market, but who were not subject to U.S. mandatory disclosure rules, showed – consistent with the bonding hypothesis – that firms cross-listed on the NYSE or NASDAQ had considerably greater abnormal returns than firms listed on OTC market. Miller also found that when a firm makes a public offering of securities in the U.S. (III level facility), there was a much stronger market reaction when the firm only listed on an exchange or NASDAQ (II-level facility). These findings may be explained from corporate governance perspective and bonding hypothesis: in addition to the antifraud liability under Rule 10b-5, to which a company subjects itself in a Level II facility, the Level III facility requires the firm to subject itself to the provisions of Section 11 of the Securities Act of 1933.

Perhaps the strongest support to the bonding hypothesis is provided by a study of foreign listing on U.S. markets by Reese and Weisbach (2002). Reese and Weisbach acknowledge that decisions may be influenced by managerial self-interest. However, managers use U.S. listing as a bonding mechanism to signal their commitment to reduce extraction of private benefits. Reese and Weisbach found that firms cross-listing from

[20] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002.

countries with weak shareholder protection (e.g. civil law tradition) are more likely to issue equity outside the U.S., while firms from countries with stronger shareholder protection (e.g. English common law countries) issue primarily inside the U.S. Thus, firms with strong protection at home tend to cross-list in order to access the U.S. markets, whereas firms from weaker corporate governance regimes cross-list for the purpose of voluntarily bonding themselves to US securities and market regulation[21].

While Coffee (1999,2002), Shleifer and Vishny, Miller (1996) and Black (199) argue that cross-listing on the US stock exchange may serve as a bonding mechanism for corporate insiders credibly to commit to a better governance regime, several academics have criticized the bonding role of cross-listing to be greatly overstated (Licht 2002, 2003; Siegel 2003). Licht argues that the bonding theory is unfounded; the role of corporate governance issues is negative in the cross-listing decision. Thus, the evidence supports an alternative "avoiding hypothesis" rather than the bonding hypothesis[22]. According to Licht, the key weakness of the bonding-by-cross-listing arguments is that they are insensitive to the fact that the U.S. securities regulation regime enforced for foreign firms differs markedly from the regime that applies to domestic American issuers[23]. Edward Rock (1999) pointed out that the existing SEC system can be understood as providing issuers with a mechanism for making a credible commitment to high quality, comprehensive disclosure for an indefinite period into the future, largely due to its monopoly over criminal sanctions in the US and a history of enforcing high disclosure requirements. However, Siegel (2003) indicates in his recent study

[21] William Reese & M. Weisbach. "Protection of Minority Shareholder Interests, Cross-Listing in the United States and Subsequent Equity Offerings". *Journal of Financial Economics* 66 (2002): 65-104.

[22] Amir Licht. "Cross-Listing and Corporate Governance: Bonding or Avoiding?". *Chicago Journal of International Law* Vol 4 No. 1 (2003): 141-163.

[23] Amir Licht. "Bonding and Dominance in Securities Markets: Cross-Listing and Corporate Governance". Working Paper 2002. Available from NSRR.

that the SEC has adopted a hands-off enforcement policy toward foreign issuers, and thus criminal and regulatory enforcement of securities laws by SEC and Department of Justice against cross-listed firms has been scant[24]. Similarly, Fanto (1996) argues that SEC disclosure requirements are not meaningful, and do not bestow any real rights to minority shareholders.

The vast majority of previous studies and critiques on the bonding hypothesis have concentrated on whether the SEC is effective in enforcing its policy hard enough to foreign issuers, or whether the reporting requirements are actually looser for foreign firms than for domestic firms. Thus, these studies have disregarded private litigations as a way to enforce the bonding within the U.S. regulatory regime. Siegel raised private litigations as a way to enforce the bonding, but argued that the private actions against foreign firms listed on U.S. exchanges were limited[25].

However, as Coffee showed in his most recent study, many private class actions involving foreign firms listed on the U.S. have been filed and settled[26]. Coffee further argues that is it a fundamental mistake to understand the deterrent threat of legal standards as synonym with the actual rate of apprehension or the actual severity of sanctions; the manner in which the legal threat is communicated is more important. According to Coffee, all that is necessary for the bonding hypothesis to have a measure of validity is that the defendant's perceived risk of liability rises marginally with its entry into the U.S. markets, not that the SEC or private enforcers will always be omniscient policemen[27].

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[24] Jordan Siegel. "Can Foreign Firms Bond Themselves Effectively by Submitting to U.S. Laws?" MIT Working Paper 2003. Available from: www.afajof.org/Pdf/2003program/articles/siegel.pdf.

[25] Based on a search of LEXIS records, Siegel argues that there were only a total of twenty-five private actions against foreign firms between the enactment of the earliest federal securities laws in 1933 and July 31, 2001.

[26] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002.

[27] Ibid

2.3 Liability of Foreignness

Most foreign direct investment (FDI) theories assume that foreign corporations are at a disadvantage to domestic firms due to their liabilities of foreignness[28]. The theories assume that transaction costs are greater for foreign firms than for their domestic counterparts because of their foreignness. Thus, firms setting up operations abroad face certain unavoidable costs that firms operating in their home environment do not have – so called liability of foreignness. Zaheer defines liability of foreignness as the additional costs of doing business abroad[29]. This liability of foreignness has been a primary assumption driving theories of the multinational enterprise. The liability of foreignness is due to higher coordination costs and lack of networks or political influence in the host country (e.g. Hymer 1976), and costs directly associated with spatial distance and geography or costs associated with a firm's unfamiliarity with the local environment (e.g. Vernon 1977, Kindleberger 1969). Thus, ceteris paribus, foreign firms would under-perform their domestic counterparts[30]. However, recent research on liability of foreignness has showed that foreign firms initially going abroad are self-selected in a sense that they possess some superior source of competitive advantage over local firms. Thus, as Lilac Nachum argues, under certain circumstances the superior advantages of MNEs outweigh the additional costs associated with foreign activity, leading to superior performance of MNEs. The original theory of the MNE relied upon static equilibrium-based assumptions, and did not discuss how the costs of

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[28] John Mezias. "Identifying Liabilities of Foreignness and Strategies to Minimize their Effects: The Case of Labor Lawsuits Judgments in the United States". *Strategic Management Journal* 2002, 23: 229-244.

[29] Srilata Zaheer. "Overcoming the Liability of Foreignness". *Academy of Management Journal* Apr 1995 38, 2. Available from ABI/INFORM Global Database.

[30] Lilach Nachum. "Liability of Foreignness and the Superior Advantages if MNEs. Financial Service MNEs in the City of London". *Strategic Management Journal* 2003, 24: 12: 1187-1208.

doing business abroad might change over time. However, later Hymer (1976) established the fact that the liability itself changes and declines over time.

Zaheer was the first one to suggest that the liability of foreignness was tied to the failure to adopt host country practices, and that this liability declines as the foreign firm remains in a particular location[31]. Zaheer argues that foreign subsidiaries that do not understand or follow host country institutional norms experience liabilities of foreignness[32]. Mezias tested the liability of foreignness with respect to labor lawsuit judgments, and concluded that foreign subsidiaries faced significantly more labor lawsuit judgments in both federal and state jurisdictions. According to Mezias, the liability of foreignness – measured by fewer lawsuits – was significantly reduced with firms using American top officers or whose parent firms had more U.S. operations[33].

In prior research, information on cross-listing and on the bonding hypothesis has not been reconciled with the theories of liability of foreignness. However, foreign firms cross-listing on the U.S. foreign exchanges similarly encounter liability of foreignness as they are unfamiliar with the SEC requirements and with the U.S. legal system. Applying the dynamic concept of liability of foreignness to the bonding hypothesis, the liability should diminish after several years cross-listed on the United States as the knowledge of the local rules and standards increases. Thus, following the logic of theories of liabilities of foreignness, foreigners should be likely to get sued more often, and this liability should decrease over time. Thus, the probability of private securities litigation filings of any type

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[31] Srilata Zaheer and Elaine Mosakowski. "The Dynamics of the Liability of Foreignness: A Global Study of Survival in Financial Services". *Strategic Management Journal*, Vol:18:6, 439-464, 1997.

[32] Yadong Luo and John M. Mezias. Editorial: Liabilities of Foreignness: Concepts, Constructs and Consequences. *Journal of International Management* 8, 217-221. 2002.

[33] John M. Mezias. "Identifying Liabilities of Foreignness and Strategies to Minimize their Effects: The Case of Labor Lawsuits Judgments in the United States". *Strategic Management Journal* 2002, 23: 229-244.

against cross-listing foreign firms should tend to converge over time with the probability of such filings against listed domestic firms.

3 U.S. Securities Law

Generally, the U.S. securities regulation has been considered the most comprehensive and detailed in the world. The most pertinent statutes governing the U.S. securities law, the Securities Act of 1933 and the Securities Exchange Act of 1934, arose from the economic rubble of Wall Street after the Crash of 1929 and the Great Depression which followed in its wake[34]. These acts were created as vehicles to prevent the recurrence of the events that led to the Crash of 1929, and to "promote the integrity of the marketplace". Securities regulation is mostly a matter of federal law in the United States. Securities transactions are regulated by the Securities and Exchange Commission (SEC), an independent agency of the federal government. The system of registration and disclosure requirements (known as prospectus) for new issues of publicly traded securities as well as the complex liability scheme for misinformation in the registration statement was established by the Securities Act of 1933[35]. The securities regulation was further developed in 1934 by enacting Securities Exchange Act of 1934, which created the Securities and Exchange Commission. The federal securities law has played a substantial role in corporate governance from the beginning, as agency concerns were at the heart of the original mandatory disclosure regime[36].

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[34] Kaveh Kashef. "Securities Law: Understanding Foreign Subject Matter Jurisdiction Under Section 10(b) of the Exchange Act of 1934". 8 *Tulane Journal of International and Comparative Law* 533, 2000. Available from LexisNexis Academic. Accessed in February 14, 2004.

[35] Roberta Romano: "*The Advantage of Competitive Federalism for Securities Regulation*". AEI Press, Washington DC 2002, 1.

[36] Kenji Taneda. "Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation". *Columbia Business Law Review* 715, 2003. Available from LexisNexis Academic. Accessed in February 14, 2004.

These detailed reporting and disclosure requirements as well as the strict enforcement mechanism[37] of the United States explains why the U.S. securities regime is often called the most detailed and comprehensive in the world. It is often acknowledged that investors are extremely well protected in the United States[38]. Thus, foreign firms cross-listing to the U.S. markets should be able to bond to higher corporate governance regime, and gain some of the benefits of the apparatus that protects investors in the U.S. Nevertheless, many academics claim that the higher corporate governance regime of the U.S. and its enforcement mechanisms are not effectively used against foreign firms, and thus they are not bonding to any higher standards[39]. This section discusses how the U.S. securities law is applied to foreign firms listed on the U.S. stock exchanges and how the three main enforcement mechanisms of the U.S. securities law mentioned by Coffee (reporting requirements, SEC enforcement and private litigations) are used against foreign firms.

3.1 Extraterritorial Reach of Securities Law of the U.S.

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 define their jurisdiction to cover securities activities between any 'foreign country' and the United States[40]. Thus, neither of them makes a distinction between domestic and foreign private

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[37] The enforcement mechanism consists of two equally important parts: the power of enforcement authority and the available sanctions against the securities regulation violations.

[38] C. Doidge et Al. "Why are Foreign Firms Listed in the U.S. Worth More?". *Journal of Financial Economics* 71, 2004, 209.

[39] Jordan Siegel. "Can Foreign Firms Bond Themselves Effectively by Submitting to U.S. Laws?" MIT Working Paper 2003. Available from: www.afajof.org/Pdf/2003program/articles/siegel.pdf. Amir Licht. "Cross-Listing and Corporate Governance: Bonding or Avoiding?". *Chicago Journal of International Law* Vol 4 No. 1 (2003): 141-163.

[40] Securities Act § 2 (7), Exchange Act § 3 (a)(17)

issuers. The jurisdictional reach of the U.S. antifraud rules, particularly Rule 10b-5[41], is especially ambivalent, as the U.S. courts have tried to balance two kinds of objectives: protecting US investors when they are investing in foreign securities, and staying popular among foreign issuers. If the regulatory environment is too rigorous, it may dissuade foreign issuers and the US securities community from making foreign securities available to US investors[42]. The U.S. courts have resolved this dilemma using two tests that liberally measure U.S. interests in the challenged transaction: 1) effects tests, according to which illegal transactions outside the United States are subject to U.S. jurisdiction if they cause a harm to US investors; and, 2) conduct tests, according to which acts in the United States that are part of fraudulent securities transactions are subject to U.S. jurisdiction even though reliance and harm occurred abroad[43]. Furthermore, the courts have often said that US securities fraud provisions have a broader extraterritorial reach than US securities filing requirements.[44]

3.1.1 Regulatory Treatment of Foreign Firms

Although neither the Securities Act of 1933 nor the Securities and Exchange Act of 1934 made a distinction between foreign or private issuers, and the Congress did not single out for special treatment foreign private issuers or their securities, the SEC later provided a number of exemptions to decrease the costs associated with listing in the U.S. It created separate registration and reporting forms for non-U.S. firms and thus created a distinct regulatory scheme for foreigners. The accommodation of foreign firms started as early as in

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[41] Rule 10b5-1 is promulgated under the Securities Exchange Act of 1934 (17 CFR 240.10b5-1), and it serves as the SEC's definition for determining trading "on the basis of" material public information in insider trading cases.

[42] Palmiter, A. "Securities Regulation: Examples and Explanations", 2nd Ed. Aspen Law &Business, NY, 2002, 428.

[43] Ibid, 428.

[44] Ibid, 429.

1935 when the SEC exempted the foreign firms from Section 14 ("the proxy rules") and Section 16 ("the short-swing profit rules") of the SEA of 1934[45]. By providing accommodations for foreign firms, the SEC wanted to support the competitive position of the American market vis-à-vis to the London Stock Exchange by attracting foreign firms to list on them[46]. The foreign firms are usually subject to a different set of disclosure and corporate governance regimes in their home countries, and thus they perceive the U.S. financial disclosure and accounting rules as a significant cost, which are far more detailed than those abroad.

The Exchange Act of 1934 requires regulatory compliance from foreign issuers that trade securities in the United States. Under Rule 12b-1 of the Exchange Act, a foreign issuer must register its securities if it chooses to list them on a U.S. stock exchange or on the NASDAQ[47]. Once the company is listed on the U.S., it becomes subject to the SEC regulations and it cannot avoid regulation even by delisting[48]. Rule 12g-3 further requires foreign issuers with total assets of over $5 million and a class of equity held by at least 500 shareholders of which at least 300 reside in the U.S. to register their equity securities and to issue an annual report of financial results within six months of the end of each fiscal year[49]. However, Rule 12g3-2(b) exempts non-U.S. firms from filing annual and periodic reports so long as they do not make public offerings in the United States or they do not list their shares

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[45] Hal S. Scott and Philip A. Illons. *International Finance. Transactions, Policy and Regulation*. 9th Ed. Foundation Press, NY 2002, 62.

[46] Amir Licht. "Cross-Listing and Corporate Governance: Bonding or Avoiding?". *Chicago Journal of International Law* Vol 4 No. 1 (2003): 141-163.

[47] James A. Fanto and Roberta Karmel. "A Report on the Attitudes of Foreign Firms Regarding a U.S. Listing". *Stanford Journal of Law, Business and Finance* 3, 51.

[48] Once listing on a U.S. stock exchange with more than 300 shareholders in the US, the only way to avoid U.S. securities regulation is to merge with a non-listed company and choose not to list the new company. Chistopher Woo: "*The Effects of the Sarbanes-Oxley Act on Foreign Private Issuers*". Seminar Paper, Harvard Law School.

[49] 17 C.F.R §§ 240.13a-16a, 249.220f(a) (2002).

on a U.S. securities exchange. Thus, foreign firms traded in the U.S. on the National Quotation Bureau's "pink sheets" or on the NASDAQ's Over-the-Counter Bulleting Board ("OTCBB") are exempted from the filing and reporting requirements of the United States. However, the foreign firm needs to provide the SEC with copies of material information made public in their home jurisdiction.

Foreign firms who list their shares on a U.S. securities exchange or make a public offering in the U.S. are not eligible for the SEA of 1934 exemption, but they have a different securities registration and disclosure requirements than U.S. issuers. The Forms 20-F and 20-K, registration and reporting forms for foreign issuers, include several exemptions from the disclosure regime pertinent to domestic issuers under Form 10-K[50]. These exemptions are generally seen as exemptions from corporate governance matters[51]. Amir Licht lists the five most important differences related to corporate governance matters between Form F-20 (required from foreign firms) and Form 10-K (required from domestic firms) requirements. 1) Disclosure of conflict of interests according to which foreign private issuers may disclose aggregate remuneration and aggregate options to purchase securities. 2) Foreign issuers are exempted from disclosing data concerning material transactions with officers, directors, and control persons. 3) Foreign issuers need to disclose the names of persons who own more than 10 percent of the issuer's voting securities, whereas the threshold for U.S. issuers is five percent. Also, foreign issuers need to report the total amount of voting securities owned by the officers and directors as a group, while domestic issuers report individual disclosure. 4)

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[50] Amir Licht "Bonding and Dominance in Securities Markets: Cross-Listing and Corporate Governance". Working Paper 2002. Available from SSRN. Accessed on November 1, 2003.

[51] See for example Kenji Taneda. "Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation". *Columbia Business Law Review* 715, 2003; Amir Licht "Bonding and Dominance in Securities Markets: Cross-Listing and Corporate Governance". Working Paper 2002. Available from SSRN. Accessed on November 1, 2003.

Foreign issuers need to file an annual report within six months after the end of the fiscal year covered whereas the U.S. issuers have 135 days time to report these financial statements to the SEC. 5) The foreign issuers eligible to use Form F-20 are also exempted from the Section § 14 ("proxy rules") and the Section § 16 ("short-swing trading and disgorgement rules") of the Securities Exchange Act of 1934.[52]

The Sarbanes-Oxley Act, enacted in 2002 in response to such corporate scandals as Enron, Arthur Andersen and WorldCom debacles, has increased corporate accountability and changed partially the special treatment of foreign issuers[53]. Kenji Taneda claims that Congress intended Sarbanes-Oxley to provide for identical treatment of domestic and foreign firms. However, the SEC has attempted to accommodate foreign issuers through a compromise approach while trying to assure that a similar outcome would be achieved under one mechanism or another. [54] Thus, the SEC ruled that foreign firms would be exempted from the law's provisions that conflict with their home country laws[55]. For example, in Germany employee representatives on the supervisory board can be counted as "independent" board members for the audit committee, whereas in the U.S. they are not part of the board[56].

Amir Licht argues that the foreign firms are not bonding to higher accounting standards and stricter corporate governance regime because of the less strict securities

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[52] Amir Licht "Bonding and Dominance in Securities Markets: Cross-Listing and Corporate Governance". Working Paper 2002. Available from SSRN. Accessed on November 1, 2003.

[53] The Sarbane-Oxley sets forth rules governing the firm's corporate governance, but it also includes rules concerning disclosure.

[54] Kenji Taneda. "Sarbane-Oxley, Foreign Issuers and United States Regulation". 715 *Columbia Business Law Review*, 2003.

[55] Foreign firms are currently exempted from Section 301, Section 302

[56] Section 302 of the Sarbane-Oxley Act requires an independent audit committee to be established, with "all responsibility for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer". However, this would lead to major changes in all firms incorporated under civil law countries. Sarbane-Oxley § 302(a). 15 U.S.C. § 7241(a)(2003).

regulation regime created for foreign firms by the SEC. The fact that the U.S. has heightened disclosure and more rigorous financial reporting requirements than other countries does not make any difference if foreign issuers are not bound by these strict rules. Coffee agrees with Licht by stating that U.S. listing is a far from a complete shield for minority shareholders, as foreign firms have different, more relaxed requirements in the U.S. and entry into the U.S. market does not change the substantive corporate governance standards of foreign firms[57]. Rules that deal with corporate governance issues tend to be left to home jurisdiction while the ones dealing with disclosure applies to foreign issuers. Even with the disclosure rules there are often accommodations.[58]

Nevertheless, foreign issuers entering into the U.S. are still bound by relatively stricter rules than in their home countries, and thus they are bonding to higher corporate governance regime. Coffee further argues that in spite the weaker standards for foreign firms, issuers may still rely with greater confidence of the issuer's statements in a U.S. prospectus for three reasons: 1) The issuer faces strict liability for material statements or omissions under Section 11 of the Securities Act of 1933; 2) Readily available private enforcement works as a legal threat in the U.S. (contingent fees and class actions); 3) More reliable gatekeepers, e.g. the U.S. based underwriters and auditors, have conducted a "due diligence" investigation into the offering, motivated in part by their own high liability for

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[57] Jack Coffee. "Competition Among Securities Market: A Path Dependent Perspective". Working Paper No. 192. The Center for Law and Economics Studies. 2002. Available from SSRN. Accessed on November 1, 2003.

[58] For Canadians, the rules are even more relaxed due to the multi-jurisdiction security disclosure initiative rule of 1991, which permitted the Canadian market to use Canadian forms for registration, but would still apply for U.S. antifraud rules. *See* Christopher Woo. "The Effects of the Sarbanes-Oxley Act on Foreign Private Issuers". Working Paper, Harvard Law School. Available from: www.law.harvard.edu/programs/pifs/pdfs/christopher_woo.pdf

negligent error or omissions[59]. Also, Fanto argues that an effective regulation of foreign issuers requires different approach to the mandatory disclosure rules, because a large part of the U.S. corporate governance disclosure regime is specific to the U.S. model of dispersed shareholders[60]. Indeed, after the enactment of Sarbanes-Oxley Act, many foreign firms, such as Germany's Porsche and Japan's Daiwa Securities Group and Fuji Photo Film announced they would delay planned U.S. stock listings due to the confusion over the regulatory environment[61]. Also, some foreign firms, such as the Benfield Group, have chosen to list on the London Stock Exchange instead of listing in the U.S. because of the too onerous regulatory measures of the U.S[62]. James Fanto and Roberta Karmel find that a major problem cited by over half of the interviewed firms was the SEC requirement of financial statement to be reconciled to US GAAP and the onerous disclosure requirements[63].

3.1.2 American Depositary Receipts and Their Regulatory Treatment

The extent, to which foreign firms gain the benefits of bonding to the U.S. corporate governance regime, depends on whether they list on an exchange, or on the over-the-counter (OTC), or on the level of the ADR they are using. A firm can cross-list its shares on a U.S. stock exchange through an American Depositary Receipts (ADR) or by listing its shares directly. Majority of foreign firms choose to cross-list their stock using ADRs, and according to Coffee (2002) firms establishing depositary facilities in the United States come

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[59] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002

[60] James A. Fanto. "The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance". 17 *Northeastern Journal of International and Business* 119, 1996.

[61] "Foreign Firms Shun U.S. Listing". Asian Wall Street Journal, July 25, 2003, M7 Cl 1.

[62] Comments of the New York Stock Exchange, Inc on S7-02-03 (February 21, 2003). Http://www.sec.gov/rules/proposed/s70203/dcstuckey1.htm. Accessed February 19, 2004.

[63] James A. Fanto and Roberta Karmel. "A Report on the Attitudes of Foreign Firms Regarding a U.S. Listing". 3 *Stanford Journal of Law, Business and Finance* 1997, 51.

heavily from emerging markets economies[64]. However, Canadian and Israeli firms especially tend to list their equity directly on a U.S. stock exchange[65]. The listing and reporting requirements are essentially same for both direct listing and for firms with an ADR. Thus, this paper examines both firms with direct cross-listing and firms with an ADR.

ADRs refer to certificates traded in the U.S. and denominated in U.S. dollars. ADRs are sold, registered and transferred in the US in the same manner as any other share of stock, with each ADR representing some multiple of the underlying foreign share. They may be listed on any of the major exchanges in the U.S. or in the over the counter market (OTC), and are subject to the Securities Act and the Exchange Act. ADRs are either sponsored or non-sponsored; sponsored ADRs are issued at the request of a foreign firm wishing its shares to be traded in the U.S., whereas unsponsored ADRs are issued at the request of U.S. investors[66]. Foreign firms with an American Depositary Receipt have exposed themselves to the risk of securities litigation in the United States. The level of the firm's legal liability depends on the level of ADR program. The SEC has sought to accommodate these programs by mandating levels of disclosure that vary according to foreign company's presence in U.S. securities markets[67].

There are four types of ADR facilities, which have legally different consequences from each other: three levels of public offerings as well as private placement. Level I ("foot in U.S. water") is the simplest way for firms to access foreign capital markets. It is designed

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[64] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002.

[65] Reese, W. & M. Weishbach. "Protection of Minority Shareholder Interests, Cross-listing in the United States and Subsequent Equity Offerings" *Journal of Financial Economics* 66 (2002): 65-104.

[66] Eiteman et al "Multinational Business Finance", 9th Ed. Addison Wesley, Boston.

[67] Palmiter, A. "Securities Regulation: Examples and Explanations", 2nd Ed. Aspen Law and Business, New York, 2002, 420.

to give US investors access to existing securities of foreign issues, and it cannot be used to raise capital[68]. Level I ADRs are traded in over-the-counter market, and they are exempted from filing annual and periodic reports under Rule 12g3-2(b). Thus, Level 1 ADRs' do not have to comply with the U.S. Generally Accepted Accounting Principles ("GAAP"), or full Securities and Exchange Commission disclosure. However, under the exemptive SEC Rule 12g3-2(b) the issuer needs to furnish the SEC with copies of reports, shareholder communications and other materials required to be prepared pursuant to regulations in its home country. Even though a Level I firm is not required to become a reporting company under the U.S.'s federal securities law, it becomes subject to SEC oversight and to private enforcement in the U.S. courts through class and derivative actions. The U.S. Court of Appeals for the Third Circuit set a precedence by ruling on May 30, 2002 that Roche Holdings, which had Level I ADRs, purposefully availed itself of the privilege of conducting activities in the American securities market and thereby "established the requested minimum contacts with the U.S." and "could reasonable anticipate being involved in litigation in the U.S."[69]. Thus, from a corporate governance perspective, even Level-I ADR bonds the company onto the U.S. regulations. The costs of setting up a Level I program are small, averaging about $25,000. However, the gains are significant, as stock prices often jump 4-6 percent[70].

Level II ADRs ("wading into U.S. waters") are traded on the NASDAQ, NYSE, or AMEX, and are usually used by firms seeking greater liquidity and investor recognition. Firms issuing Level II ADR's are not exempted under Rule 12g3-2(b). They are required to

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68 Palmiter, A. "Securities Regulation: Examples and Explanations", 2nd Ed. Aspen Law and Business, New York, 2002, 420.

69 Pinker v. Roche Holdings Ltd, 2002 1086684, 3rd Cir. N.J., May 30, 2002.

70 Palmiter, A. "Securities Regulation: Examples and Explanations", 2nd Ed. Aspen Law and Business, New York, 2002, 420.

register with the SEC pursuant to Section 12(b) of the Securities Exchange Act of 1934 and to enter the periodic disclosure system established by Section 13 of SEA. Thus, foreign issuers must reconcile to U.S. GAAP, report quarterly, and annually file Form 20-F with the SEC and meet the listing requirements of the particular U.S. exchange where they trade. In addition to these legal requirements, foreign firms listing to the U.S. exchange are exposed to the scrutiny of "reputational intermediaries" including U.S. underwriters, auditors, and securities analysts[71]. Level II ADR faces antifraud liability under Rule 10b-5. Finally, they will entail greater costs, averaging over $1 million. Nevertheless, the increased access to U.S. investors and the increased stature that comes from U.S. GAAP disclosure may increase share price by 10-15 percent[72].

Level III ADRs ("swimming in U.S. waters") is the only program that allows foreign issues to raise new equity capital in a public offering in the U.S. By making a public registered sale in the United States, the foreign issuer avails itself of the strict liability provision of Section 11 of the Securities Act of 1933 in addition to the Rule 10b-5 liability. Moreover, a public offering in the United States requires the issuer to prepare a detailed registration statement (usually Form F-1), which will provide more current information than the typical Form 20-F. From the corporate governance perspective, by using Level-III ADR the foreign issuer has bonded itself to higher corporate governance standards than what would be required from Level I or II ADRs. They trade on the NASDAQ, NYSE, or AMEX. A public offering in the US typically costs in excess of $1.5 million[73].

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[71] Coffee, J. C. "Racing Towards the Top: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance", 102 *Columbia Law Review* No 1757, 2002.

[72] Ibid, 421.

[73] Ibid, 421.

A foreign issuer may raise capital in the U.S. and avoid the U.S. disclosure requirements by privately placing securities with sophisticated professional institutional investors. The Rule 144A establishes a safe harbor standard for institutional trading and facilitates a secondary market in restricted securities by allowing reselling of the securities to "qualified institutional buyers. The 144A market is typically used by those foreign issuers who are not ready to register with the SEC, but wish to place a relatively small amount (up to $50 million) of securities in the United States[74].

3.2 Legal Enforcement Mechanism

Claims both under section 10(b) and Rule 10b-5 of the Exchange Act can be claimed even if the issuer's securities are not registered with the SEC. Rule 10b-5 is enforced in three levels: private 10b-5 actions, SEC enforcement (injunctions and other equitable remedies) and 10b-5 criminal action instituted by the U.S. Justice Department[75].

3.2.1 SEC Enforcement and Criminal Actions

The U.S. Securities Exchange Commission has very extensive power in enforcing the securities regulation of the United States, and these powers extend extraterritorially. The SEC has the authority to conduct investigations to determine whether there as been a violation of federal securities law[76]. Its investigation powers are broad in the informal investigation phase. The SEC may request information on a voluntary basis without Commission authorization. For the formal investigation, it needs to have an authorization

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[74] Palmiter, A. "Securities Regulation: Examples & Explanations", Aspen Law & Business, New York, 2002, 421-422.

[75] Ibid, 270-271.

[76] See SEA § 21, SA §§ 19,20(a). Coffee, J. & J. Seligman "Federal Securities Laws. Selected Statutes, Rules and Forms". Foundation Press, 2003 Ed.

from the Commission, but then it may use the Commission's subpoena power to compel witnesses to testify or to produce books, records, and other evidence[77]. An important aspect of SEC's authority is that the conduct of an SEC investigation is subject to the same testimonial and related privileges as a judicial proceeding, including the attorney-client privilege, the fourth amendment prohibition against unreasonable search and seizure and the Fifth Amendment protection against self-incrimination[78].

The SEC can initiate civil and administrative proceedings to investigate and prevent violations. In 1990, the Congress gave the SEC the power to impose civil penalties up to $500,000 and/or order disgorgement of profits in administrative proceedings. According to Ratner and Lee Hazen, it is fairly common that respondents make offers of settlement, consenting to lesser sanctions and SEC publication of its findings of violation in order to save the prolonged adverse publicity of a protracted proceeding[79].

The SEC also has authority to issue cease and desist orders against persons found to be violating or about to violate the securities law, whether or not such persons were registered with the SEC[80]. The SEC can also initiate court action to seek injunctive relief or refer matters involving violations of securities laws to the Justice Department for criminal prosecution[81]. The courts have not established a very strict standard for granting injunctions under Section 21(d). A proper showing requires merely that the SEC demonstrate a violation

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[77] Newkirk, T. and M. Robertson: "SEC Speech: Insider Trading – US Perspective", 16th International Symposium on Economic Crime Jesus College, Cambridge, England, September 19, 1998; available from: http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm.

[78] Ratner, D.L and T.L. Hazen, "Securities Regulation in a Nut Shell", 7th Ed. St. Paul, Minnesota 2002, 245-246.

[79] Ibid, 253.

[80] See SEA §§ 21B, 21C. Coffee, J. & J. Seligman "Federal Securities Laws. Selected Statutes, Rules and Forms". Foundation Press, 2003 Ed.

[81] Palmiter, A. "Securities Regulation: Examples & Explanations", Aspen Law & Business, New York, 2002, 21-22.

of the securities law, and a reasonable likelihood that there will be future violations. Moreover, the SEC has not been required to meet traditional requirements for equitable relief such as irreparable harm[82].

In enforcement actions involving foreign persons or firms, the SEC exercises its powers both unilaterally and in cooperation with foreign securities authorities[83]. The Securities and Exchange Commission has been criticized for taking a lenient approach against foreign firms[84]. However, as the number of foreign firms listed on the U.S. stock exchanges has steadily grown and foreign firms have also been involved in fraud scandals (e.g. Cendant and Bre-X Minerals), both SEC and Department of Justice have increased their level of scrutiny directed at foreign registrants[85]. Also, the SEC stated in its 2002 annual report that it continued to increase the interaction with foreign regulators and conducted joint investigations.

3.2.2 Private Securities Litigations

The amount of private litigations under federal securities law has grown rapidly in recent years and it may be seen today as the primary enforcement mechanism of securities law[86]. Moreover, the number of private securities litigations against foreign firms has dramatically increased during the last decade. During 2002, 23 foreign issuers were named as

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[82] Brainbridge, Stephen "Insider Trading: Overview". *Encyclopedia of Law and Economics* 2000, 1. Available from Lexis Nexis Universe. Accessed in September 22, 2003, 463.

[83]. Palmiter, A. "Securities Regulation: Examples & Explanations", Aspen Law & Business, New York, 2002, 430.

[84] According to Coffee, the SEC had initiated some 54 legal actions against foreign firms between January 1995 and June 2002, but it took legal action against just five foreign firms with listed ADRs. See John C. Coffee, Jr. "Racing Towards the Top?: The Impact of Cross-Listing and Stock Market Competition on International Corporate Governance". Working Paper No. 205, the Center for Law and Economic Studies, Columbia Law School. May 30, 2002.

[85] PriceWaterhouseCoopers LLP: 2002 Foreign Securities Litigation Study. Available from www.10b-5.com

[86] Ratner, D.L and T.L. Hazen, "Securities Regulation in a Nut Shell", 7th Ed. St. Paul, Minnesota 2002, 258.

defendants in private securities lawsuit compared to 13 foreign issuers in 2001. The number of cases filed against foreign firms increased 43% from year 2001, and 65% from the record of 6 cases filed in 1996[87].

There are three different types of provisions in federal securities law that may give rise to civil liabilities: 1) explicit private right of action created by provisions §§ 11, 12 of the Securities Act of 1933 and by provision § 16(b) of the SEA; 2) provisions purporting to affect legal relationships between private parties, but not explicitly creating a right of action (SEA § 29(b)), and 3) provisions prohibiting certain actions or declaring them unlawful, including the general antifraud prohibition § 10(b) of the Securities Exchange Act[88]. Foreign firms trading on the U.S. stock exchanges are liable under all these provisions, except § 16(b) of the SEA. As the courts began formalizing rules enabling large class actions[89] against foreign firms and their insiders for violation of the federal securities laws, private securities litigation and the rule 10b-5 became increasingly popular among private parties[90]. Today most of the securities suits in the US are brought under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934[91]. The rule states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
> (a) to employ any device, scheme, or artifice to defraud

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[87] PriceWaterhouseCoopers Database on Securities Litigations 1996-2002.

[88] Ratner, D.L and T.L. Hazen, "Securities Regulation in a Nut Shell", 7th Ed. St. Paul, Minnesota 2002, 258-259.

[89] The class action provisions of the Federal Rules of Civil Procedure (FRCP) permit one or more of the affected persons to bring an action on behalf of the entire class. The federal procedural rule governing class actions imposes four basic requirements - numerosity, commonality, typicality and adequacy of representation - on any proposed class. Plaintiffs' attorneys who seek to represent a class first must demonstrate that the class they define n164 meets these four requirements.

[90] Klein, William A. & John C. Coffee, Jr. Business Organization and Finance: Legal and Economic Principles. Foundation Press, NY, 2002, 158.

[91] *See* Jordan Siegel. "Can Foreign Firms Bond Themselves Effectively by Submitting to U.S. Laws?" Working Paper MIT, 2003; Ratner, D.L and T.L. Hazen, "Securities Regulation in a Nut Shell", 7th Ed. St. Paul, Minnesota 2002, 258-259.

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of circumstances under which they were made, not misleading, or
(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security"[92].

Thus, the Rule 10b-5 prohibits the making of any false or misleading statements in connection with purchase and sale of securities or practicing fraud. Claims both under section 10(b) and Rule 10b-5 of the Exchange Act can be claimed even if the issuer's securities are not registered with the SEC. The law on Rule 10b-5 has developed merely in the traditional common law manner, with federal courts and other tribunals deciding each case on the basis of precedents. The very first case on this jurisprudence was *Re: Cady, Roberts, and Co* (40 S.E.C 907, 1961), when the SEC decided that Rule 10b-5 prohibited insider trading. It was however left unclear whether it presaged general application of Rule 10b-5 to insider trading. Hence, *SEC v. Texas Gulf Sulphur Corp* (401 F.2d 833, 1968) is seen as the most important case where the 10b-5 insider trading policing started[93]. It established two distinct principles. First, it held that insiders violated Rule 10b-5 when they traded on material non-public information. Second, the firm was found to have violated Rule 10b-5, because its inaccurate press release caused some shareholders to sell their shares at an undervalued price[94].

The scope of corporate liability for false and misleading statements was further expanded by the Supreme Court decision in *Basic Inc. v. Levinson* in 1988 (485 U.S. 224, 108

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[92] 17 C.F.R § 240.10b-5 (2003).

[93] In Texas Gulf Sulphur, the corporate officers bought substantial amounts of stocks after learning and before announcing publicly – promising news about exploratory drilling on some of the company's oil and gas properties. The SEC convinced the courts that the disclosure requirements of Rule 10b-5 impose a duty on every securities trader not to lie about material facts, but also persons with inside information must either disclose the information or abstain from trading in those securities until the information is disclosed publicly.

[94] Klein, William A. & John C. Coffee, Jr. Business Organization and Finance: Legal and Economic Principles. Foundation Press, NY, 2002, 158.

S. Ct. 978, 99 L. Ed. 2nd 194)[95]. After Basic, the liability under Rule 10b-5 was no longer limited to instances of lying to investor, but also that investors are entitled to rely on the 'integrity of the market price'[96]. This ruling has created a very broad and substantial liability of corporations under the Rule 10b-5. Later, the Supreme Court restricted the scope of the Rule 10b-5 by requiring a proof of 'scienter', i.e. that the agents of the corporation either knew the information on the market was materially inaccurate, or were 'reckless' about the possibility that this was the case[97].

A drastic increase in the number of civil lawsuits after 1960s, and a concern about the potential for abuse in class action litigations against publicly-held firms for alleged mis-statements led Congress to adopt the Private Securities Litigation Reform Act of 1995 (PLSRA)[98]. The PLSRA erects a series of procedural barriers to securities fraud cases intended to discourage meritless suits and reduce the cost of defending class actions[99]. The PLSRA raises the standard of specificity that the plaintiff must meet, and thus the proportion of overall securities fraud cases ending in dismissal has increased since the

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[95] In Basic, the corporation was asked by the press to comment on rumors that it was involved in merger transactions. Basic issued a press release where it said it was not involved in such negotiations. However, in reality the company was engaged in such negotiations, and the share price had begun to rise.

[96] Klein, William A. & John C. Coffee, Jr. Business Organization and Finance: Legal and Economic Principles. Foundation Press, NY, 2002, 158-160.

[97] Ibid, 160.

[98] According to Hillary A. Sale, the accounting industry lobbied aggressively for the PLSRA, and claimed that meritless claims were filed against publicly held firms largely for settlement value. Congress ended up enacting the PLSRA, even though solid data on securities fraud class actions were not presented. *See* Hillary A. Sale. Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PLSRA'a Internal-Information Standard on '33 and '34 Act Claims. "Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PLSRA's Internal-Information Standard on '33 and '34 Act Claims". *76 Wash. U. L. Q. 537, 555* (1998).

[99] A.C. Pritchard and Hillary A. Sale. "What Counts as Fraud? Empirical study of Motions to Dismiss Under the Private Securities Litigation Reform Act". Working Paper John Ohlin Center #03-011, August 11, 2003. Available from: http://www.law.umich.edu/centersandprograms/olin.papers.htm. Accessed October 15 2003.

passage of the PLSRA[100]. Johnson *et al.* found that the PLSRA has furthered Congress's goal of discouraging frivolous securities lawsuits[101]. However, the number of suits being filed did not decline after 1995; on the contrary it increased and exceeded its pre-PLSRA level.

The private securities cases are very often targeting high-technology, biotechnology and other emerging or fast-grow firms, especially in California's Silicon Valley[102]. The lawsuits are often filed not only against the company and its management, but also its directors, major shareholders, and venture capital investors who are characterized as insiders or control persons of the corporation.

3.3 Concluding Remarks

The claims about foreign firms having less onerous and rigid filing requirements in the United States seem to be valid. The SEC has exempted foreign firms from many important parts of the reporting and filing requirements under the U.S. securities law. Historically, the SEC has not imposed its rules on foreign issuers subject to equivalent measures in their home countries. However, the exemptions are not due to lack of interest toward regulating foreign firms, but because of the endogenous differences in the corporate governance structure between civil and common law countries. Thus, the extraterritorial reach of U.S. securities filing requirements is limited.

It is important to distinguish between the extraterritorial reach of the U.S. securities filing requirements and the U.S. securities fraud provision. The U.S. courts have been able to

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100 *See* Johnson, Marilyn F. et al, "Do Merits Matter? Class Actions Under the Private Securities Reform Law", Working Paper No 02-011 September 2002, John M. Olin Center. Available from: http://www.law.umich.edu/ centersandprograms/olin.papers.htm. Accessed in November 10, 2003.

101 Ibid.

102 Ibid.

establish a broader extraterritoriality for the U.S. securities fraud provision, and thus foreign firms with a lower level of commitment to the U.S. markets (Level I ADR) are held liable under the U.S. securities fraud provisions. Consequently, the threat of securities litigation under securities fraud provisions bond the foreign firms to the U.S. corporate governance regime and to the same insider trading rules than the U.S. based firms are bound to.

4 Data and Methodology

4.1 Methodology

To empirically analyze private securities litigations against both domestic and foreign firms, I have obtained a sample data of 1,367 sued firms from PriceWaterHouseCoopers LLP. Out of these 1,367 sued firms, 90 are foreign incorporated firms. I was able to find the needed information on the lawsuit as well as financial and accounting data for 804 domestic firms and 86 foreign firms. In addition, I randomly chose a control group of 915 firms of which 67 were foreign firms listed on a US stock exchange. Thus, my final data consisted of 1805 firms, of which 153 were foreign incorporated out of the 1805 firms, 890 (out of which 86 were foreign) were targets of private securities lawsuits. From these 890 firms, 81 had been targets of shareholder lawsuits within the prior three years.

The financial and accounting data were obtained from the Center for Research in Securities Prices (CRSP) and Compustat databases. The status of the securities lawsuits has been determined using the information on the websites of some larger law firms[103] as well as the Stanford Securities Class Action Clearinghouse (http://securities.stanford/edu). Data from these sources, along with disclosures in firms' 10-K Legal Proceedings sections, were used to identify the date the lawsuit was filed, the lawsuit outcome, and the time and the amount of a possible settlement.

[103] Milberg Weiss, Wechsler, Harwood LLP, Granny & Binkow LLP, Cohen, Milstein, Hausfeld & Toll, PLLC, Entwistle & Cappucino LLP, Verteris Securities Class Action Directory, Kaplanfox.com, Berman de Valerio Pease Tobacco Burt & Pucillo, BLB&G, and The Pomerantz Law Firm.

4.2 Proxies for Litigation Risk

Several previous studies have examined the main determinants of shareholder litigation. Based on this prior research, I construct a set of variables that are intended to capture these forces based on the prior research to predict securities class action lawsuits.

First, I examine whether firms in certain industries tend to be sued more often than others. Francis et al (1994) and Johnson et al (2001) have identified that litigation risk is higher for firms in biotechnology, computer hardware and computer software, and electronic industries[104]. Jones and Weingram (1996b) find that high technology firms were twice as likely as other firms to be sued during 1989-1992[105]. Grundfest and Perino (1997) study confirmed that high technology firms continue to be target of litigation also after the enforcement of Private Securities Litigation Reform Act[106]. Thus, I created an indicator variable that takes the value "1" if the firm's primary 4-digit SIC code is within these high litigation risk industries, and zero otherwise.

The first set of variables consists of stock market variables, such as market value and stock price volatility, to predict securities class action lawsuits. Jones and Weingram explain the higher litigation risk of technology firms by the characteristics reflected in stock market variables: the probability of litigation is directly related to firm size, share turnover, and low

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[104] Johnson, M. et al "The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms" *Journal of Accounting Research* 39, 2001; Francis, J. D. Philbrick, and K. Schipper. "Shareholder Litigation Disclosures". *Journal of Accounting Research* 137, 1994: 32-45.

[105] Jones and Weingram, "Determinants of 10b-5 Litigation Risk", Working Paper, George Washington University, 1996.

[106] Grundfest, J. A. and Michael A. Perino, "Ten Things I Know and Ten Things I Don't Know About the Private Securities Litigation Reform Act of 1995", Joint Written Testimony of Joseph A. Grundfest and Michael A. Perino before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate, on July 24, 1997. Available from www.securities.stanford.edu.

prior-year returns[107]. Firm size (measured as the market value, MV[108]) is predicted to increase the litigation risk since the "deep pockets" of large firms attract litigation and larger damages may be collected from the firm. Hence, the probability of being sued is higher for larger firms, as are the potential damages. Research done by Skinner (1997), Francis, Philbrick and Schipper (1994) shows similar kinds of results: market value, share turnover and high volatility of stock returns are positively associated with the incidence of lawsuits[109]. Johnson et al (2001) find that the probability of litigation also increases with equity beta, and skewness of annual returns[110]. Because the market values of firms ranged from $429,000 to $336,725 million, I took the natural log of the market value[111]. I calculated the volatility of stock in the following way:

$$r^2 = \frac{1}{T-1}\sum_{t=1}^{T}(R_t - \overline{R})^2,$$

where:

R_t = monthly stock return for period t

$\overline{R}$ = mean stock return

T = the total number of months.

I calculated the monthly stock return R_t from monthly closing prices given by Compustat:

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107 Jones and Weingram, "Determinants of 10b-5 Litigation Risk", Working Paper, George Washington University, 1996.

108 Market value is calculated in the following way: closing price of the stock times the number of shares outstanding.

109 Skinner, D, "Earnings disclosures ad Stockholder lawsuits" *Journal of Accounting and Economics* 23, 1997: 249-282; Francis, J. D. Philbrick, and K. Schipper. "Shareholder Litigation Disclosures". *Journal of Accounting Research* 137, 1994: 32-45.

110 Johnson, M. et al "The Impact of Securities Litigation Reform on the Disclosure of Forward-Looking Information by High Technology Firms" *Journal of Accounting Research* 39, 2001

111 In addition, 19 firms had a market value of "0", because they had filed for bankruptcy.

$$R_t = \frac{P_t}{P_{t-1}} - 1$$

The mean stock return $\overline{R}$:

$$\overline{R} = \frac{1}{T}\sum_{t=1}^{T} R_t$$

The second set of variables includes the most important accounting measures used in prior research. Frankel et al (2003) used the debt-to-equity ratio as a proxy for variability in operating performance, as increased variability in operating performance may lead to variability in stock prices and thus increase the probability of lawsuits. Beneish (1997) and Johnson et al (2001, 2002) find that leverage and sales growth are positively associated with probability of GAAP violation. Growth firms are commonly believed to have greater incentives to commit financial statement fraud to meet their earnings targets, whereas high leverage is associated with more aggressive financial reporting and accounting choices[112]. DuCharme et al (1999) and Heninger (2001) find that abnormal accruals have a significant positive relation to subsequent litigation, but settlements are negatively related[113]. These findings suggest that insiders may commit fraud to maintain the appearance of success during a financial downturn[114]. Previous research shows that firms characterized by poor performance face greater litigation risk (e.g. Frankel et al, 2003), where poor performance is

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[112] See John J. Shon. "The Relation Between Earnings Performance and Discretionary Disclosure Behavior in Periods of Bad Economic News". Dissertation Working Paper, Graduate School of Business, University of Chicago, January 2003. Available from: http://business.rutgers.edu/departments/ac-papers/RARF-Shon-041803.pdf. Accessed in November 1, 2003.

[113] DuCharme et al "Earnings Management: IPO valuation and subsequent performance" *Journal of Accounting, Auditing and Finance* 16 2001: 369-396; William Heninger. "The Association between Auditor Litigation and Abnormal Accruals". *The Accounting Review* Vol 76 1, 2001.

[114] Marilyn Johnson et al. "Do Merits Matter? Class Actions Under the Private Securities Reform Law". Working Paper No 02-011. John Olin Center for Law & Economics. Available from hht://www.law/umich.edu /centersandprograms/olin.papers.htm. Accessed in September 14, 2003.

measured by the return on sales. Thus, I include such accounting variables as the debt-to-equity ratio, sales, and return on sales.

5 Descriptive Analysis[115]

5.1 Foreign Firms Listed on a United States Stock Exchanges

The number of foreign firms listed on the US stock exchanges increased during 1996-2002[116]. The impact of the increased number of cross-listings has been especially pronounced on the NYSE. In 2002, 17% of all NYSE listed firms were foreign firms compared to 10.5% in 1996. Interestingly, while foreign listings increased, domestic listings on the NYSE declined. European stocks have led the way in the NYSE (particularly France, Netherlands and the UK), followed by Latin American stocks, and their share has increased during 1996-2002. In 2002, out of 473 foreign stocks 177 were European and 100 were Latin American. Even though NASDAQ is the dominant stock exchange among the technological firms, the NYSE has been able to encourage foreign technology firms. Especially telecom firms have been interested on NYSE (e.g. Mobile TeleSystems (MBT), Rostelecom (ROS) and Vimpel-Communications (VIP) from Russia, Nokia from Finland, and France Telecom (WFA) from France). The number of foreign firms listed on other stock exchanges has also increased during 1996-2002, nevertheless with a slower pace. For example, the percentage of foreign firms listed on NASDAQ increased from 6.6% in 1996 to 9.2% in 2002.

The NYSE has a reputation as a leading repository of high disclosure standards and market transparency, and the fact that foreign firms have lately shown more interest in NYSE than in other stock exchanges suggests that they want to opt for the most rigorous stock exchange. Concurrently, large part of foreign firms listed on the NYSE come from

[115] It is important to notice that this descriptive analysis is a first cut, where different sample groups are directly compared to each other, and none of the firm characteristics are controlled.

[116] I used NYSE, NASDAQ, AMEX and OTC websites to gather information about foreign firms listed on the exchanges: www.nyse.com, www.nasdaq.com, www.amex.com, www.otcbb.com

emerging market economies and civil law countries in Europe and Latin America. This finding is consistent with a Reese and Weisbach study that suggested that civil law firms' motivation to access US market was the purpose of voluntarily bond themselves to higher disclosure standards and corporate governance regime. The finding is also consistent with the study of Schrage and Vaaler, according to which emerging market countries had particularly strong incentives to cross-list based on the bonding hypothesis[117].

NYSE

Number of Listed Firms

	1996	1997	1998	1999	2000	2001	2002
Foreign	304	356	379	406	434	462	473
Domestic	2603	2691	2735	2619	2428	2336	2310
Total	2907	3047	3114	3025	2862	2798	2783
Foreign firms %	10.5%	11.7%	12.2%	13.4%	15.2%	16.5%	17.0%

NASDAQ

Number of Listed Firms

	1996	1997	1998	1999	2000	2001	2002
Foreign	360	454	455	424	360	322	371
Domestic	5074	5466	5068	4829	4734	4109	3663
Total	5434	5920	5523	5253	5094	4431	4034
Foreign firms %	6.6%	7.7%	8.2%	8.1%	7.1%	7.3%	9.2%

AMEX

Number of Listed Firms

	1996	1997	1998	1999	2000	2001	2002
Foreign					48	45	42
Domestic		776	770	769	765	691	680
Total	0	776	770	769	813	736	722
Foreign firms %	-	-	-	-	5.9%	6.1%	5.8%

[117] Burkhard Schrage and Paul Vaaler. "Home Country Corporate Governance and the bonding Hypothesis: Evidence from Emerging-Markets". Working Paper, August 1-6, 2003.

OTC

Number of Listed Firms

	1996	1997	1998	1999	2000	2001	2002
Foreign	415	401	225	227	134	-	169
Domestic	4912	5660	6263	5145	3766	-	3404
Total	5327	6061	6488	5372	3900	-	3573
Foreign firms %	7.8%	6.6%	3.5%	4.2%	3.4%	-	4.7%

Our data reveal that foreign firms listed on a US stock exchange have remarkably bigger market value than the domestic firms listed on the US stock exchange, measured by mean market value ($11,197 million vs. $3,748 million) and median market value ($1,056 million vs. $267 million). The difference is significant both economically and statistically (t-value of -4.9). Hence, there is a clear selection bias with foreign firms which cross-list on a US stock exchange: foreign firms which cross-list on a US stock exchange tend to be larger and economically stronger. This selection bias might be explained by the high fixed costs of cross-listing.

5.2 Private Securities Lawsuits against Foreign Firms

The PWC dataset demonstrate an increase in the number of filed class action lawsuits between 1996 and 2002. In 2002, 218 cases were filed, 81 more than in 1996[118]. Securities class actions against foreign issuers have increased from 5.8% in 1996 to 10.6% in 2002. In 2002, an unprecedented 23 foreign issuers were named in private securities class actions; an increase of 63% over the 13 cases filed in 2001. Using a simple percentage as an indicator of the probability to get sued, it seems that foreign firms are little less likely to get sued than domestic firms. The probability to get sued is very small for both foreign and

[118] The number of cases does not include Initial Public Offering ('IPO') laddering cases (i.e. underwriters allocated shares to customers who agreed to buy additional shares in the aftermarket at progressively higher prices).

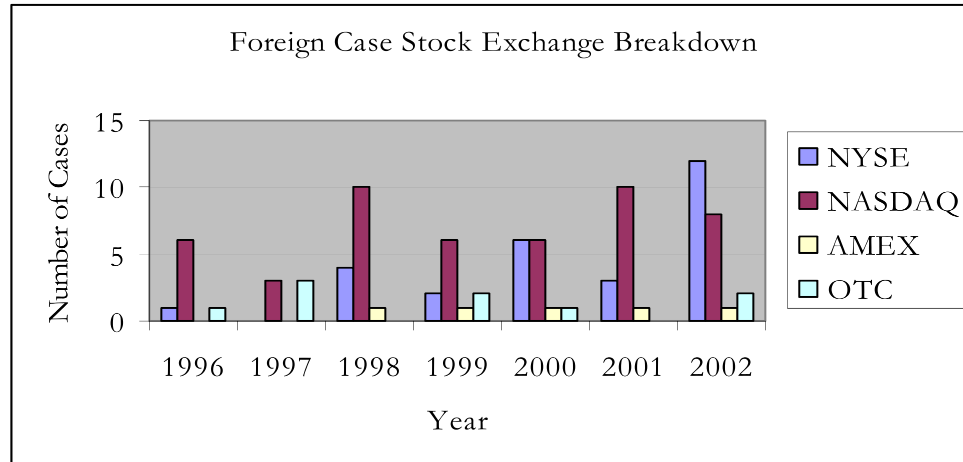
domestic firms, varying from 0.5% to 3.5%. It is also important to acknowledge that since the number of observations is lower for sued foreign firms, too much confidence cannot be put on the result. For example, the probability to get sued for foreign firms listed on AMEX is 2.5%, whereas for domestic firms listed on AMEX it is only 0.3-1.2%. Nevertheless, the absolute number of sued foreign firms listed on AMEX is only one firm per year, and thus the result is not very robust.

Total Number of Sued Firms

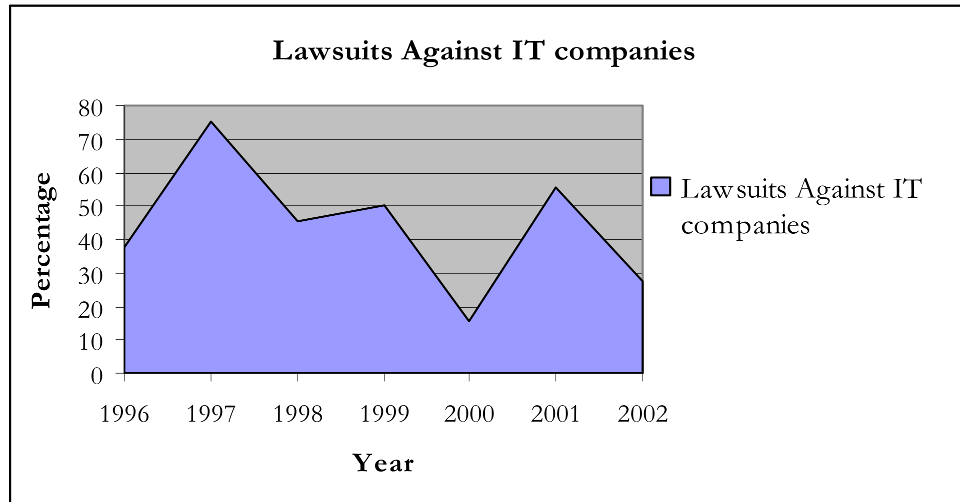
	1996	1997	1998	1999	2000	2001	2002	Total
Foreign	8	6	15	11	14	13	23	90
Domestic	129	165	238	199	187	164	195	1277
Total	137	171	253	210	201	177	218	1367
Foreign %	5.8%	3.5%	5.9%	5.2%	7.0%	7.3%	10.6%	6.6%
Domestic %	94.2%	96.5%	94.1%	94.8%	93.0%	92.7%	89.4%	93.4%

During 1996-2001, the majority of foreign registrants subject to securities class action lawsuit were listed on the NASDAQ. However in 2002, 52% of the foreign registrants subject to securities lawsuit were listed on the NYSE, whereas 35% of the foreign targets were listed on the NASDAQ. This reduction in filings against NASDAQ listed firms may be partly related to the reduction in filings against firms in the technological industries, as they are typically listed on the NASDAQ. Moreover, the data reveal that the probability for a foreign registrant of getting sued has traditionally been higher for firms listed on NASDAQ than for firms on different exchanges. However, in 2002, the probability of getting sued for a NYSE listed foreign company increased noticeably from 0.6% to 2.5%. This observation is consistent with the fact that lawsuits against foreign firms in IT industries fell in 2002 dramatically, as the number of lawsuits against firms listed on NASDAQ declined. According to the study of Grundfest and Perino (1997) high technology firms continue to be

target of litigation. However, the data reveals that this trend might have changed as the percentage of sued IT foreign firms was much lower in 2002 than in the previous years.



It is worth noting that the median time sued foreign firms have been listed on a US stock exchange before the lawsuit is three to four years, except in 2002 when both the median and mean time were 5 years. This result might suggest that there is a liability of foreignness during the first three to four years, because the company is not so well acquainted with the US corporate governance regulations. Over time the foreign firm learns better to follow the rules and standards of the US and thus the probability of getting sued decreases. The same outcome may be found by studying the cross-listing dates of foreign non-sued firms. On average, non-sued foreign firms have cross-listed on a U.S. stock exchange in 1990, whereas the sued foreign firms were cross-listed in 1995. Among the non-sued foreign firms, the year of cross-listing varies considerably more than among the sued foreign firms. The year of cross-listing varies between 1939 and 2003 for non-sued foreign firms, whereas the sued foreign firms have cross-listed on a U.S. stock exchange between 1974 and 2002.



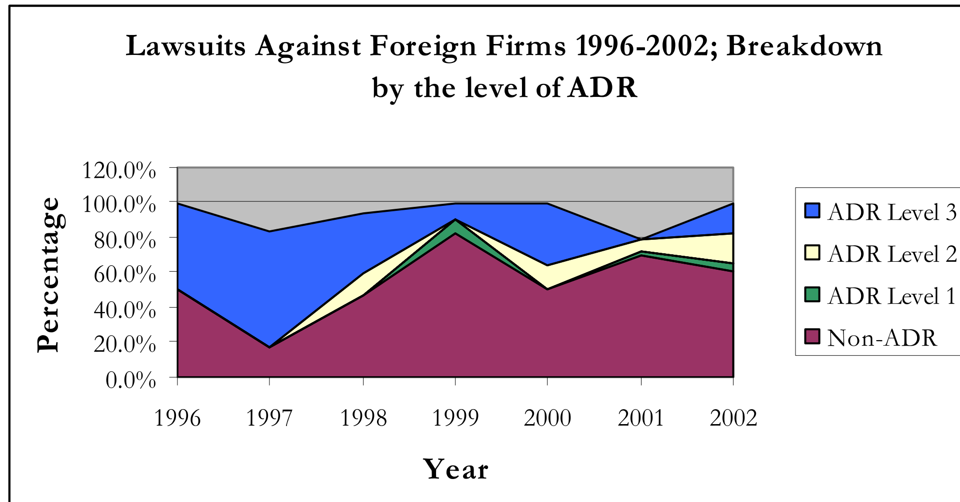
In terms of the geographical dispersion of foreign registrants sued during 1996 and 2002, European firms experienced the largest increase in the number of cases filed against them. Canadian, Irish, British and Argentinean firms were only foreign registrants sued in 1996 and 1997. From 1998 other foreign registrants were increasingly sued, and by 2002 private class actions were filed against registrants from ten different foreign countries. Bermuda had the highest incidence of securities litigation cases during 2002.

Lawsuits against foreign firms with direct equity listing were prevalent during the examined time period; on average more than half of the lawsuits were against foreign firms who listed their equity directly on a U.S. stock exchange. The percentage of lawsuits against firms with direct equity listings stayed high in spite of the falling number of lawsuits against Canadian and Israeli firms[119]. This high level of lawsuits is largely due to an increase in lawsuits against foreign firms from Bermuda (they do not usually use ADRs to list their equity on a U.S. stock exchange). Interestingly, foreign firms which were not sued, were less often listed directly on a U.S. Stock exchange than those foreign firms who were sued.

[119] Canada and Israel are countries whose firms tend to list their equity directly on the US stock exchanges rather than through an ADR.

It is interesting to notice that the number of lawsuits against foreign firms with Level 1 and Level 2 ADRs increased over the last three years. This tendency reveals the fact that the US courts were able to establish a broader extraterritoriality for the securities fraud provision and thus foreign firms with lower levels of commitments are now liable under the U.S. securities fraud provisions. Foreign firms with lower levels of commitments bond to the US securities regime.

Consistent with studies done by Skinner (1997), Francis, Philbrick and Schipper (1994), the average market value of sued domestic firms was greater than those who were not sued ($5,012 million vs. $2,973 million). This result confirms that deep pockets induce shareholders to sue firms. Captivatingly, this wasn't true for foreign firms: the mean market value of non-sued foreign firms was higher than that of the sued foreign firms ($12,552 million vs. $ 9,826 million). One reason could be that larger firms are better established in the US and they have more resources to familiarize themselves with the complex the US securities regulations, whereas smaller firms have a higher liability of foreignness by not being able to learn the US disclosure rules so quickly. This result is also corroborated by the following outcome: the non-sued foreign firms with Level 1 and Level 2 ADRs have considerably higher sales than those foreign firms who are sued. The mean volatility of sued foreign firms was a little higher than that of the foreign firms in the control group (0.94283 vs. 0.1360793). However, the difference is not statistically significant.



Dismissals

On average, more cases against domestic firms were dismissed during 1996-2002 than against foreign firms (25.1% vs. 17.4%). Interestingly, the trend is even more noticeable with cases filed after 2000: the percentage of dismissed foreign cases filed after 2000 is clearly lower than the percentage of dismissals of cases against domestic firms. Simultaneously, there were more pending cases against foreign firms (55.8%) than against domestic firms (40.1%). By breaking down the pending cases by the year the case was filed, the data shows that the percentage of pending cases filed the same year was still higher for foreign firms than for domestic firms. This higher ratio of pending cases against foreign firms might partly be explained by the lower ratio of dismissals, and the fact that foreign firms are disinclined to settle.

Settlements

The data shows that foreign firms do not settle cases more often than domestic firms; in fact it seems that domestic firms settle faster the cases than foreign ones. This finding is contradictory to Clermont and Eisenberg's argument that foreign subsidiaries

would be prone to settle or abandon most claims. The fact that foreign firms are less prone to settle than domestic firms is worthy of note in particularly in the in the light of consolidation of actions[120]: 64% of cases against foreign firms were consolidated, whereas 54% of cases against domestic firms were consolidated. One could expect firms to be more likely to settle when the actions have been consolidated, or after the certification of the class[121]. However, the data suggests that the consolidation of actions has not put enough pressure on foreign firms to settle the cases.

Settlement Summary Statistics

	All Settlements	Foreign Firms Settlements	Domestic Firms Settlement
Obs	366	33	333
Minimum ($)	70,000	70,000	125,000
Median ($)	5,550,000	9,000,000	5,450,000
Average ($)	24,900,000	24,200,000	25,000,000
Maximum ($)	1,400,000,000	300,000,000	1,400,000,000

Furthermore, the settlement amounts between foreign and domestic firms are comparable[122]. The mean settlement amount for foreign firms is $24.2 million whereas the mean settlement amount of domestic firms is $25 million[123]. The difference in the average settlement amount is not statistically or economically significant. Then again, the median settlement amount is significantly higher for foreign firms ($9 million vs. $5.45 million). The

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[120] Black's Law Dictionary defines the consolidation of cases in the civil procedure in the following way: "to combine, through court order, two or more actions involving the same parties or issues into a single action ending in a single judgment or, sometimes, in separate judgments". Bryan Garner. Black's Law Dictionary. Abridged, 7th Edition.St Paul, Minnesota, 2000. The consolidation of cases is based on Rule 42 of the Federal Rules of Civil Procedure.

[121] For example, Kathy L. Cerminara found that class actions put great pressure on defendants to settle even cases they would not settle were only one or two plaintiffs involved. "The Class Action Suit As a Method of Patient Empowerment in the Managed Care Setting". 24 *American Journal of Law & Medicine* 7, 1998. Available from Lexis Nexis. Accessed in January 15, 2004.

[122] This paper studies cash settlements and does not take into account non-cash components

[123] Excluding the Cendant Corporation settlement of $1.4 billion, the average of settlement amount among domestic firms is $21.1 million.

considerable difference between the mean and median foreign settlement amount reveals the fact that there is some outliers that make the data noisy in terms of the foreign settlement amounts.

The data reveal that the average settlement amounts differ greatly between the stock exchanges. The mean settlement amount is highest for firms listed on the NYSE, where the average settlement amount for domestic firms listed on the NYSE is $51.7 million and for the foreign firms it is as high as $81.5 million. This difference between the mean settlement amount of foreign firms listed on the NYSE and domestic firms listed on the NYSE is statistically significant. However, it seems that foreign firms listing on the NYSE are self-selected in a sense that their market value is much higher ($ 23.399 million) than the average market value ($4,480 million) of foreign firms listing on other US stock exchange. This observation suggests that settlement amounts are highly correlated with the market value of the firm.

Settlement amounts for firms with prior shareholder lawsuits[124] tend to be higher than firms without prior lawsuits. The mean settlement amount for firms with prior lawsuits is $58.9 million. The difference between the average settlement amount of $21.8 million for non-prior lawsuits firms and of $58.9 million for prior-lawsuits is economically important. This result suggests that firms with prior lawsuits might be scared of their earlier experiences, and they are more prone to settle with higher settlement amounts than firms without prior lawsuits. However, because of the small sample size (31 firms that have prior lawsuits), the result is not statistically significant (t-value of -1.93).

[124] Prior three years

The average settlement amount for high-tech firms was lower ($12.5 million) than the mean settlement amount ($34.7 million). However, even thought the difference between the means is economically noteworthy not statistically significant (t-value of 1.2). This result is interesting, as the firms in the technological industries have been the most common target in the lawsuits. Nevertheless, these cases apparently are settled for lower amounts relative to other industries.

We can find out the ceteris paribus effects of these different independent variables on the settlement amount by estimating the following model[125]:

$$\log(amount_i) = \gamma_0 + \gamma_1 \log(mktv_i) + \gamma_3 foreign_i + \gamma_8 tech_i + \gamma_9 plawsuit_i + u_i$$

Where:

$\log(amount_i)$ = the logarithm of the settlement amount for firm i

γ_0 = intercept term for the y-axis

$\log(mktv_i)$ = the logarithm of the market value for firm i

$foreign_i$ = Firm i is incorporate in a foreign country

$tech_i$ = Firm i is a technological company

$plawsuit_i$ = Firm i has been sued in the previous three years

u_i = error term

As a method of estimation, I chose the Ordinary Least Squares method (OLS). The first major finding of the regression is that foreignness does not have a statistically significant effect on the settlement amounts. Altogether we need to acknowledge that the economic significance of foreignness is remarkable: the data suggest that foreign firms tend to have on average 39% larger settlement amounts than domestic firms, holding everything else

[125] I did not include other economic variables in the regression because of the correlation effect between sales, net income and market value.

constant. However, the data is insufficient to conclude this result by statistical certainty, as the number of foreign firms settlement amounts is relatively low. Thus, the result is economically significant but because of the small size of the dataset, the result is not statistically significant.

The second finding is that holding all other independent variables constant, the settlement amount increases by 25% with one percent change in the market value. This change is both economically and statistically significant. The result is consistent with earlier studies, which suggested the relationship between settlement amount and company's market value is positive.

Third, the results suggest that firms with earlier lawsuits pay on average 66% higher cash settlement amounts. The percentage is economically very significant. However, at the same time we need to acknowledge that the 95% confidence interval is very wide and thus we can't put too much confidence on this result. The data is insufficient (81 observations with prior lawsuits) to draw any convincing conclusions.

6 Conclusion

As foreign firms all over the world are increasingly cross-listing on US stock exchanges, there is an unanimity among academics that foreign firms benefit from it in several ways: lower cost of capital, increasing stock liquidity, firm visibility and larger stockholder base. However, there is debate about whether firms from countries with lower securities regulation are effectively bonding to the higher US corporate governance regime. The most common critique against the bonding hypothesis has focused on the fact that foreign firms are bound to less stringent disclosure standards in the US than the domestic firms and that the SEC has not been vigorously enforcing the securities regulations against foreign firms.

Large accounting scandals during the last years have induced the Congress to enact more severe corporate governance regulations for both foreign and domestic firms. Foreign firms are increasingly treated equally with domestic firms. Nevertheless, the standards remain lower for foreign firms today. Even though the extraterritorial reach of U.S. securities filing requirements is limited, the U.S. courts have been able to establish a broader extraterritoriality for the U.S. securities fraud provision. Thus foreign firms with a lower level of commitment to the U.S. markets (level I ADR) are held liable under the U.S. securities fraud provisions. Consequently, the threat of securities litigation under securities fraud provisions bond the foreign firms to the U.S. corporate governance regime and to the same insider trading rules than the U.S. based firms are bound to. Thus, private securities litigation has an opportunity to serve as a mechanism to enforce bonding with the US securities regulation.

The descriptive analysis reveals that foreign firms are increasingly interested in cross-listing on the NYSE and voluntarily bonding to the most stringent securities regulations. Most of the new cross-listing on the NYSE are from civil law countries and from emerging markets. This finding is consistent with the prior research on the bonding hypothesis that firms from lower corporate governance regime are motivated the most by the bonding reasons to cross-list.

The data reveal that during the last three years, private securities litigations have increasingly served as mechanism bond foreign firms to the US securities regulations. The number of lawsuits increased during the last three years remarkably, and foreign firms tend to be sued about as often as domestic firms. The average time the sued foreign firm had been listed on a US stock exchange was three to four years. This time is relatively short and it suggests that there is a liability of foreignness – the probability to get sued diminishes over time for foreign firms as they become more familiar with the US securities regulations.

In conclusion, the private securities cases force foreign firms to bond to the US securities regime. Foreign firms are treated uniformly with domestic firms, and the likeliness to get sued is similar kind to both foreign and domestic firms. The data is insufficient to further conclude how liability of foreignness affects the process of securities litigations. The data shows that with respect to the settlement amount, holding everything else constant, foreign firms pay on average higher settlement amounts than domestic firms. However, the data is inconclusive about its statistical significance as the number of observation is relatively small (33).

As an exploratory study, this paper focused more on the descriptive analysis of the data in the light of the larger body of research done on the bonding hypothesis. Follow-up

research might look further the role of private securities cases as a mechanism to enforce foreign firms to bond with the US securities regulation by using more elegant models and robustness checks on the dependent variables. Moreover, a model with time series could reveal how the liability of foreignness changes over time for firms cross-listing in the U.S.

Appendix

Variable Description

Name	Decription
1. General information	
Lawsuit	=1 if the company is sued, 0 otherwise
SIC	Standard Industrial Classification
Tech	=1 if high-tech company, 0 otherwise
gvkey	Firm specific number
nyse	=1 if company listed on NYSE, 0 otherwise
nasdaq	=1 if company listed on NASDAQ, 0 otherwise
amex	=1 if company listed on AMEX, 0 otherwise
otc	=1 if company listed on OTC, 0 otherwise
2. Financial Data from Compustat	
year	year
assets	Data 6 – Assets Total MM$
debt	Data 9 – Long term debt
sales	Data 12 – Sales Net MM$
shares	Data 25 – Common shares outstanding MM
price	Data 199 – Price close ($&c)
mktv	Market value (Data25*Data 199)
debtequity	Debt-to-equity (Data 9/Market value)
ros	ROS (Data 172/Data 12)
vol	Volatility
3. Information on Foreign Firms	
finc	Foreign incorporation number by Compustat
foreign	=1 if foreign incorporation, 0 otherwise
crosslisting	Date of Cross-listing
adr	=1 if adr, 0 otherwise
level1	=1, if level of ADR 1, 0 otherwise
level2	=1, if level of ADR 2, 0 otherwise
level3	=1, if level of ADR 3, 0 otherwise
sponsored	=1 if sponsored ADR, 0 otherwise
4. Information on Securities Litigations	
year	Year filed
plawsuit	=1 if company has been sued during the last 3 years, 0 otherwise
pending	=1 if pending, 0 otherwise
settled	=1 if settled, 0 otherwise
settledate	Year of settlement
amount	Settlement cash amount
dismissal	1= if case dismissed, 0 otherwise

Technology industries (TECH)

SIC Code	Description
2800	Chemicals and Allied Products
2820	Plastics, Materials, and Synthetic Resins
2833	Medicinal Chemical Botanical Products
2834	Pharmaceutical Preparations
2835	In Vitro and In Vivo Diagnostic Substances
2836	Biological Products
3555	Printing Trades Machinery and Equipment
3570	Computers and Office Equipment
3571	Electronic Computers
3572	Computer Storage Devices
3575	Computer Terminals
3577	Computer Peripheral Equipment
3578	Calculating and Adding Machines
3661	Telephone and Telegraph Apparatus
3663	Radio and Television Broadcasting and Communications Equipment
3674	Semiconductors and Related Devices
3695	Magnetic and Optical Recording Media
3822	Automatic Controls for Regulating Commercial and Residential Climate
3823	Industrial Instruments for Measurement, Display, and Control of Process Variables
3825	Instruments for Measuring and Testing of Electricity and Electrical Signals
3826	Laboratory Analytical Instruments
3827	Optical Instruments and Lenses
3841	Surgical and Medical Instruments and Apparatus
3842	Orthopedic, Prosthetic, and Surgical Appliances
3844	X-ray Apparatus and Related Irradiation Apparatus
3845	Electromedical and Electrotherapeutic Apparatus
3861	Photographic Equipment and Supplies
4822	Radio Telegraph Services
7372	Prepackaged Software
7373	Computer Integrated Systems Design
8731	Commercial, Physical, and Biological Research

Source: Gerry McNamara and Paul Vaaler: "*Is Dynamic Competition Greater in Technology-Intensive Industries?*". Working Paper 2003, Regulatory Policy Program, Center for Business and Government, Harvard University.

T-test for market value by the dummy variable "foreign"

```
------------------------------------------------------------------------------
   Group |     Obs        Mean    Std. Err.   Std. Dev.   [95% Conf. Interval]
---------+--------------------------------------------------------------------
       0 |    1685     4019.49    419.3166    17212.42    3197.054    4841.927
       1 |     150    11025.82    1958.103    23981.76    7156.586    14895.06
---------+--------------------------------------------------------------------
combined |    1835    4592.215    419.1908    17956.84    3770.073    5414.357
---------+--------------------------------------------------------------------
    diff |           -7006.333    1521.681               -9990.744   -4021.922
------------------------------------------------------------------------------
Degrees of freedom: 1833
                      Ho: mean(0) - mean(1) = diff = 0
     Ha: diff < 0               Ha: diff != 0              Ha: diff > 0
       t =  -4.6043               t =  -4.6043              t =  -4.6043
```

Conclusion: market value is (statistically) significantly larger for foreign firms

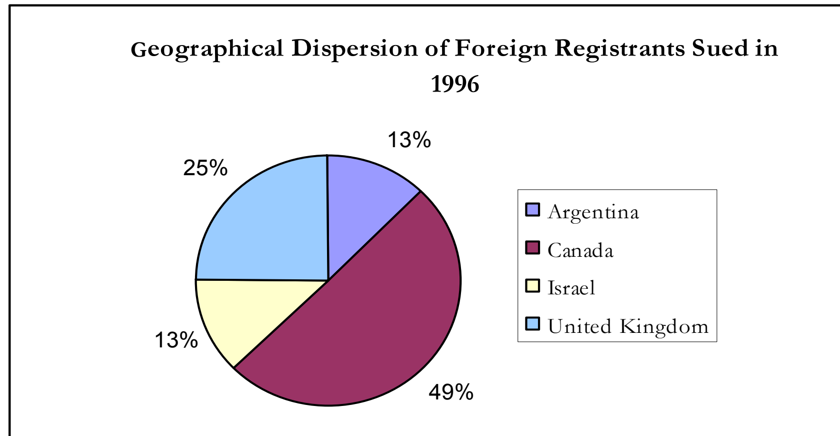
Sued Firms in TI Industries

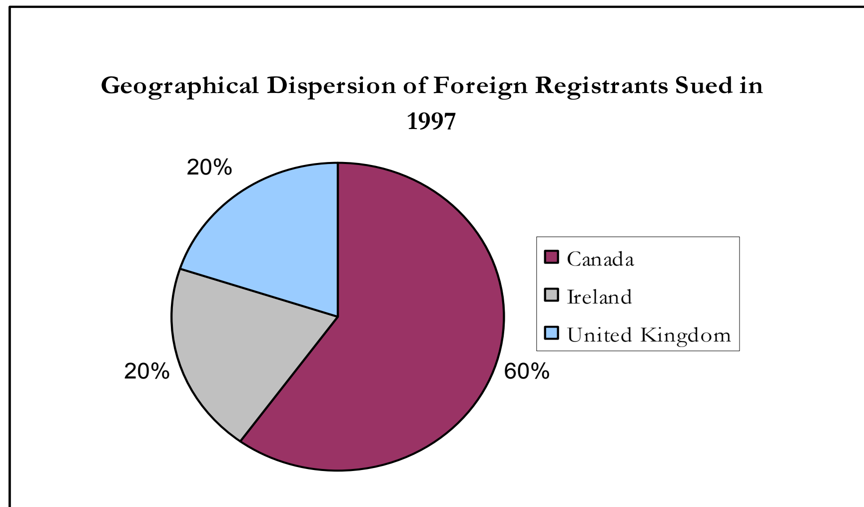
	1996	1997	1998	1999	2000	2001	2002	Total
Foreign (#)	4	1	7	3	2	6	7	30
Domestic (#)	48	50	71	52	65	58	48	392
Total	52	51	78	55	67	64	55	422
Foreign (%)	50.0%	16.7%	46.7%	27.3%	14.3%	46.2%	30.4%	33.3%
Domestic (%)	37.2%	30.3%	29.8%	26.1%	34.8%	35.4%	24.6%	30.7%
Total (%)	38.0%	29.8%	30.8%	26.2%	33.3%	36.2%	25.2%	30.9%

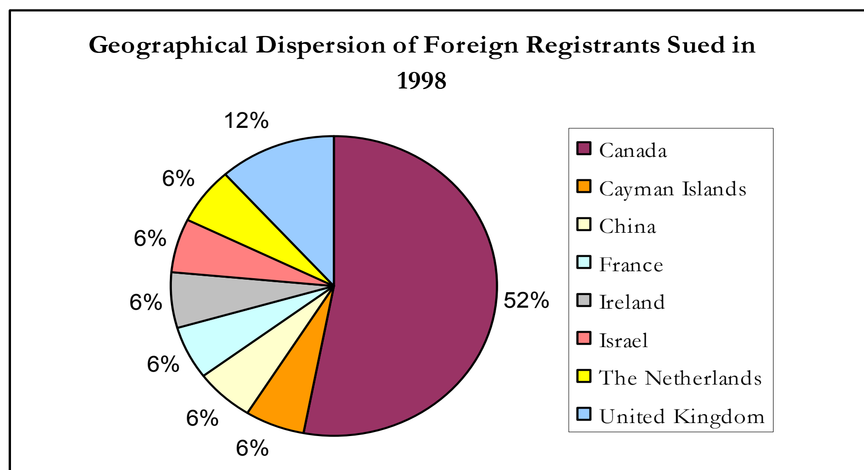
Probability to Get Sued by Stock Exchange Breakdown

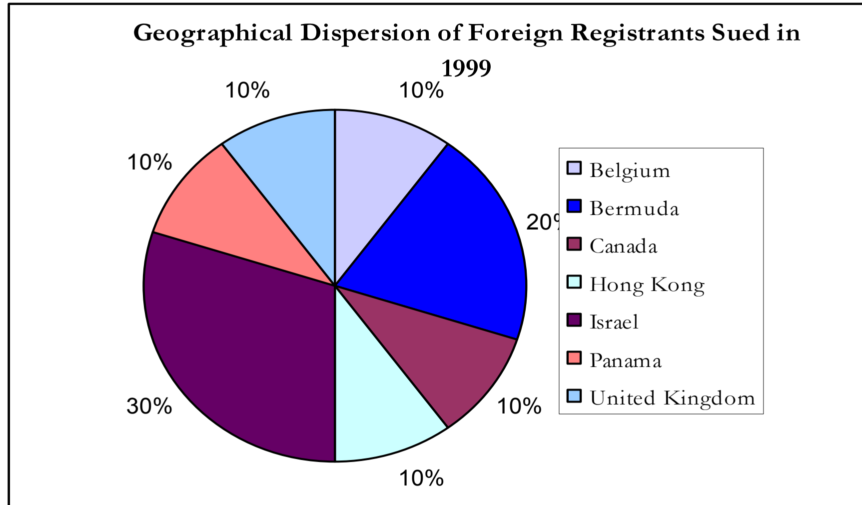
		1996	1997	1998	1999	2000	2001	2002
NYSE	Foreign %	0.3%	0.0%	1.1%	0.5%	1.4%	0.6%	2.5%
	Domestic %	0.8%	1.7%	1.1%	2.5%	2.2%	2.1%	3.8%
NASDAQ	Foreign %	1.7%	0.7%	2.2%	1.4%	1.7%	3.1%	2.2%
	Domestic %	1.6%	1.8%	3.0%	2.3%	2.6%	2.5%	2.5%
AMEX	Foreign %	-	-	-	-	2.1%	2.2%	2.4%
	Domestic %	-	0.8%	0.6%	1.2%	0.3%	0.3%	1.2%
OTC	Foreign %	0.2%	0.7%	0.0%	0.9%	0.7%	-	1.2%
	Domestic %	0.5%	0.3%	0.3%	0.3%	0.2%	-	0.3%

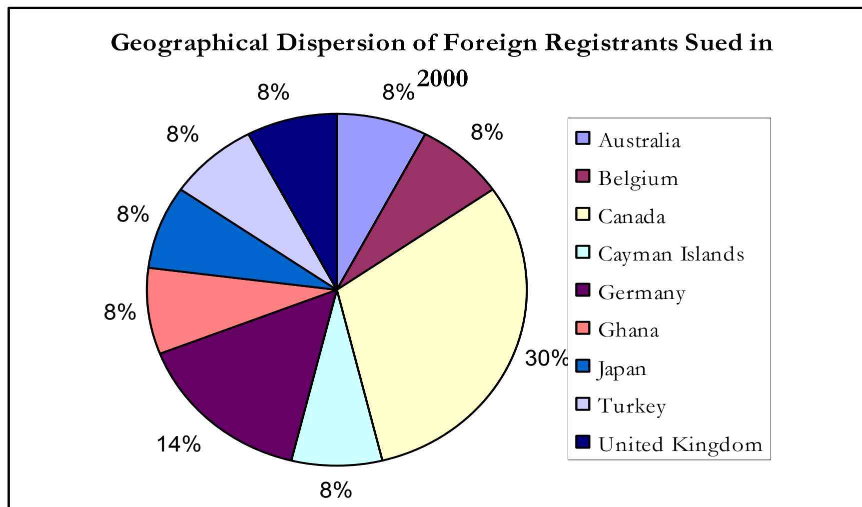
Geographical Dispersion of Foreign Registrants Sued during 1996 - 2002

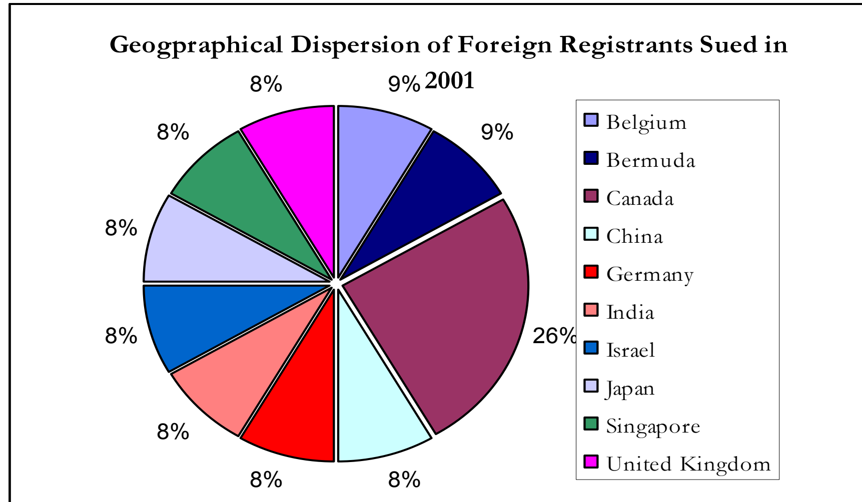


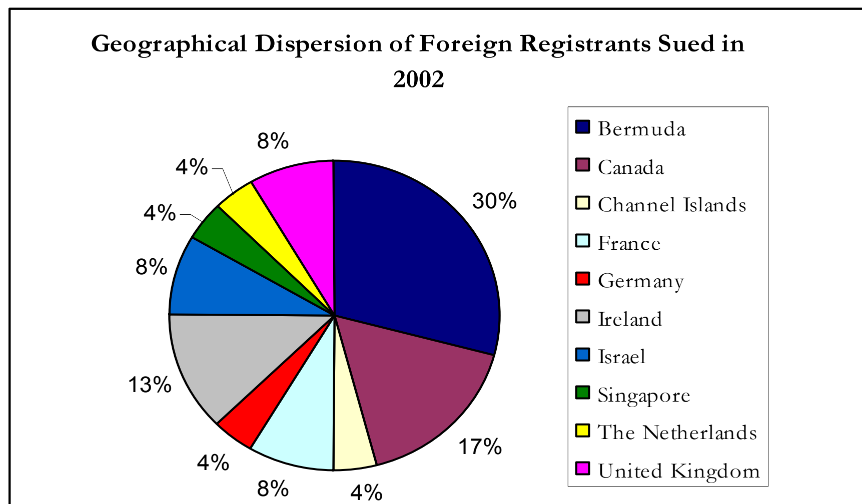





Geographical Dispersion of Foreign Registrants Sued in 1999
10%
10%
10%
20%
30%
10%
10%
Belgium
Bermuda
Canada
Hong Kong
Israel
Panama
United Kingdom


Geographical Dispersion of Foreign Registrants Sued in 2000
8%
8%
8%
8%
8%
8%
30%
14%
8%
Australia
Belgium
Canada
Cayman Islands
Germany
Ghana
Japan
Turkey
United Kingdom





Percentage of Dismissed Cases Filed Between 1996-2002

Year Filed	Foreign Firms	Domestic Firms
1996	22.2%	21.1%
1997	25%	20%
1998	27.3%	27.7%
1999	41.7%	31.4%
2000	7.7%	29.6%
2001	11.1%	19.6%
2002	4.5%	9.3%
Total	17.4%	25.1%

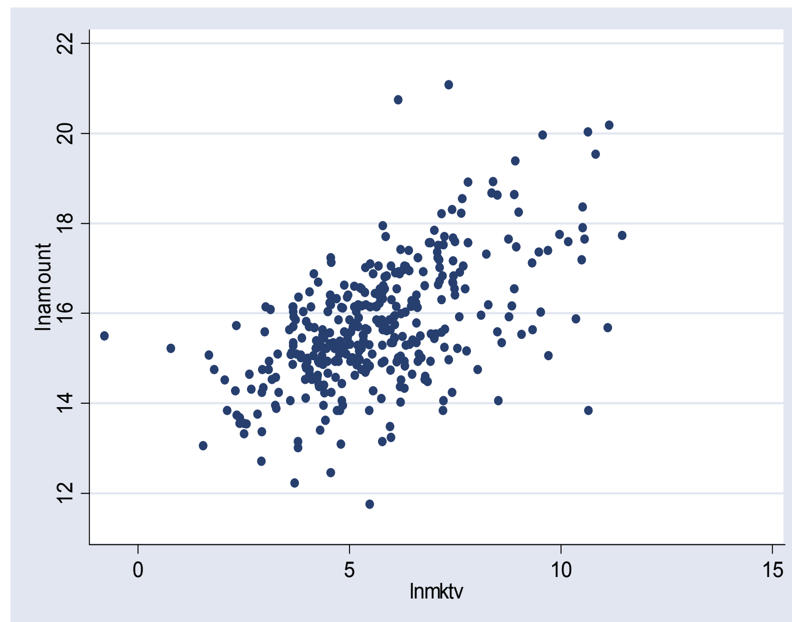
Percentage of Pending Cases Between 1996 - 2002

Year Filed	Foreign Firms	Domestic Firms
1996	11%	7 %
1997	0%	7.5 %
1998	9%	11.5 %
1999	25%	17.9 %
2000	38%	36.2 %
2001	55%	43.7 %
2002	90%	78.9 %
Total	55.8%	40.1%

Summary Statistics on the Settlement Amounts by Stock Exchange – Comparison to Mean Market Value of listed firms on the stock exchange

US Stock Exchange	Foreign Firms		Domestic Firms	
	Avg Settlement Amount	Avg Market Value (MM$)	Avg Settlement Amount	Avg Market Value
NYSE	81,500,000	23,399	51,700,000	9,571
NASDAQ	9,541,667	1,580	1,710,000	1,927
AMEX	1,500,000	1,545	2,891,400	100

Scatter Plot Log of Settlement Amount and Log of Market Value



OLS Results

Dependent variable: Log(Settlement Amount)

Independent Variable	Coefficient
log(market value)	.254 (0.03)
Volatility	-1.10 (.51)
Foreign	.33 (.25)
Tech	.39 (.14)
Plawsuits	.50 (.25)
Observations R-Squared	0.25

Note: The quantities in the parentheses below the estimates are the standards errors

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