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The Rise of Foreign Ownership and Corporate Governance

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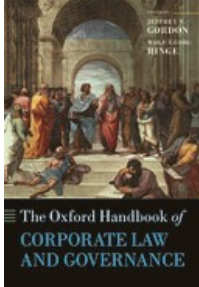
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CHAPTER

29 The Rise of Foreign Ownership and Corporate Governance

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Abstract

This chapter explores the link between corporate governance and the rise of foreign ownership. It presents statistics that illustrate the dramatic rise in foreign ownership over the last few decades and then seeks to explain this rise and its relationship to corporate governance. In order to situate the subject under study within its larger context, this explanation starts with an exploration of the factors independent of corporate-governance considerations that favor a global market for securities and those that impede it. It will be shown that the rise in foreign ownership globally can be explained in significant part by the weakening of the impeding factors. The chapter then shows why, as a matter of theory, improvements in corporate governance can be expected to cause a rise in foreign ownership and a rise in foreign ownership can be expected to cause improvements in corporate governance, with the weakening in the non-corporate-governance factors that impede a global market for securities acting as a catalyst for the causal pathways going in both directions. The chapter concludes with a review of substantial empirical evidence suggesting that both causal pathways are in fact at work.

Keywords: [corporate governance](#), [foreign ownership](#), [investor holdings](#), [equities](#), [securities](#), [portfolio investment](#), [diversion constraints](#)

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1 Introduction

ONE of the most striking changes in the world's capitalist economies has been the rise of cross-border share ownership over the last two decades. This chapter is devoted to understanding the relationship between this rise and corporate governance.

The chapter begins by documenting this rise statistically. Then, in order to situate the subject under study within its larger context, it explores the factors independent of corporate-governance considerations that favor a global market for securities and those that impede it. It will be shown that the rise in foreign ownership globally can be explained in significant part by the weakening of these impeding factors. The remainder of the chapter is devoted to the interaction between the rise in foreign ownership and corporate governance.

The underlying theme of the chapter is as follows. The demand outside a country for the shares of its issuers is determined both by how much the forces impeding a global market for securities have weakened and by

the corporate governance of the country's issuers. This observation suggests pathways of causation between increased foreign ownership and improved corporate governance that run in both directions. For each, the weakening of the forces independent of corporate governance that impede a global market for securities acts as a catalyst. As they weaken, foreign ownership increases, leading to improved corporate governance, which in turn leads to increased foreign ownership. More specifically, we will consider the role of the weakening of these impeding forces in the following three regards.

p. 785 First, a weakening of the forces impeding a global market for securities leads to a greater potential increase in foreign ownership for issuers in a poor governance jurisdiction if these issuers then in fact credibly improve their governance. This increased opportunity to tap the large global pool of capital abroad creates incentives for any country with a poor corporate-governance regime to make improvements. It also creates incentives for individual issuers ↴ within the country to improve their own governance above and beyond whatever floor is set by the country's overall regime. To the extent that countries and firms respond to these incentives, foreign ownership increases.

Table 29.1 Proportion of US investor holdings in foreign issuers and the proportion of foreign issuer holdings of US issuers, 1993

	US Issuer Equity	Non-US Issuer Equity	Total
Equity market capitalization	\$5.2 trillion (37%)	\$8.9 trillion (63%)	\$14.1 trillion
Holdings by US investors	\$4.9 trillion (94%)	\$.3 trillion (6%)	\$5.2 trillion
Holdings by non-US investors	\$.3 trillion (3%)	\$8.6 trillion (97%)	\$8.9 trillion

Note: Figures in the 1993 table come from the following sources: US equity market capitalization in 1993 = \$5.2 trillion, Securities & Exchange Commission, Annual Report, 28 (1994) available at: https://www.sec.gov/about/annual_report/1994.pdf; worldwide equity market capitalization in 1993 = \$14.1 trillion (non-US equity market capitalization = \$14.1 trillion – \$5.2 trillion), id.; holdings by non-US investors of US equity securities in 1993 = \$340.0 billion, Russel B. Scholl, The International Investment Position of the United States in 1994, Survey of Current Business, June 1995, at 52; holdings by US investors of non-US equity securities in 1993 = \$297.7 billion, id.; holdings by US investors of US equity securities in 1993 = \$5.2 trillion – \$340 billion = \$4.9 trillion; holdings by non-US investors of non-US equity securities = \$8.9 trillion – \$297.7 billion = \$8.6 trillion.

Second, some countries with poor corporate-governance regimes improve their regimes for reasons independent of the weakening of the forces impeding global share investing. With a weakening of the impeding forces, however, the improvement in corporate governance leads to a greater increase in foreign holdings of the shares of their issuers than would have been the case without the weakening.

Third, a weakening of the forces impeding a global market for equities leads to more foreign investors purchasing shares in issuers from countries with poor corporate governance even if, at the time, there is no improvement in their corporate governance. As the foreign investors acquire a larger portion of the outstanding shares of these issuers, they generate new pressure for governance improvement.

2 Documenting the Rise in Foreign Ownership

p. 786 The dramatic rise in foreign ownership is illustrated in Tables 29.1 and 29.2, which compare 1993 and 2015 in terms of the proportion of US investor holdings in foreign issuers and of the proportion of foreign issuer holdings of US issuers. Comparing Table 29.1 with Table 29.2, we can see that over these 22 years, the proportion of non-US equities in US investor stock portfolios, and the proportion of US equities in the portfolios of non-US investors, have each more than quadrupled. ↴

Table 29.2 Proportion of US investor holdings in foreign issuers and the proportion of foreign issuer holdings of US issuers, 2015

	US Issuer Equity	Non-US Issuer Equity	Total
Equity market capitalization	\$25.1 trillion (41%)	\$36.7 trillion (59%)	\$61.8 trillion
Holdings by US investors	\$20.5 trillion (75%)	\$6.8 trillion (25%)	\$27.3 trillion
Holdings by non-US investors	\$4.6 trillion (13%)	\$29.9 trillion (87%)	\$34.5 trillion

Note: Total market capitalization figures for US issuers and foreign issuers are derived from World Bank, Market Capitalization of Listed Companies, <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD>. The cross-border holdings of both US and foreign investors come from Int'l. Monetary Fund, Coordinated Portfolio Investment Survey (2015) Table 11.1, available at <http://cpis.imf>.

The same pattern can be observed at the more granular country-to-country level. For example, in 1989, Japanese investors on average held only 0.3% of their portfolios in US issuer stocks and US investors on average held only 1.3% in Japanese issuer stocks.¹ In 2015, Japanese investors on average held 8.2% of their portfolios in US issuer stocks, a twenty-seven-fold increase in the proportion held, and US investors on average held 2.5% in Japanese issuer stocks, an almost twofold increase in the proportion held² (a much more significant increase than it appears because the market capitalization of Japanese stocks as a proportion of the total capitalization of all the world's publicly traded issuers dropped from 28% in 1995³ to 8% in 2015⁴).

While starting from a much lower base, similar trends can be observed in the case of various emerging economies. US investors on average held only 0.02% of their portfolios in Indian stocks in 1994, but by 2015 the figure was up to 0.44%, a twenty-two-fold increase; for South Korea, the comparable figures are only 0.09% for 1994 and 0.51% for 2015, a more than fivefold increase.⁵

p. 787 Finally, and importantly for our later discussion of the influence of foreign ownership on corporate governance in such countries, there has been a sharp increase in the proportion of the shares of issuers from countries with less well regarded corporate-governance regimes held by investors from countries with more well regarded regimes. Between 1994 and 2015, the proportion of Japanese issuer stocks held by US investors increased from 2.7% to 14.1%, a more than fivefold increase; for South Korea, the comparable figures increased from 2.3% to 11.3%, a more than fourfold increase; for India, the comparable figures increased from 0.9% to 7.9%, an almost ninefold increase; and for Brazil, the comparable figures increased from 4.5% to 13.5%, a three fold increase.⁶

All in all, at year end 2012, 38% of the capitalized value of all the world's publicly traded issuers was held by investors from a country different from that of the issuer.⁷

3 Trends in Non-Corporate-governance Factors Affecting the Extent of Foreign Ownership

As will be developed below, under ideal conditions, the typical passive portfolio investor around the world, to maximize her utility, should hold an equity portfolio containing shares of issuers of different countries roughly in proportion to the countries' respective total market capitalizations.⁸ Thus, for example, a US and a Japanese passive investor should each have a portfolio with about 8% invested in Japanese corporations and 41% in US ones. This is because the market capitalization of Japanese public companies represents 8% of the total market capitalization of the world's publicly traded issuers and that of US corporations represents 41%.⁹

If all investors around the world followed this rule, all corporations would be predominantly foreign owned. Keeping with our examples, as the figures in Table 29.2 reveal for 2015, US investors held about 44% of the equity wealth in the world and non-US investors hold the remaining 56%, including 8.0% that is held by Japanese investors.¹⁰ So the typical US corporation would have 56% of its shares owned by non-US investors, compared with 13% today.¹¹ Japanese investors hold about 8% of the equity wealth in the world and non-Japanese hold the remaining 92%, including the 44% that is held by US investors.¹² Therefore the

typical Japanese corporation would have 92% foreign ownership (compared to 18% today) including 44% of the ownership coming from US investors (compared with only 9% today).¹³ These figures show that while there has been a striking increase in cross-border ownership of equity over the last two decades, there would be potential for much more if the remaining impediments to a global market for securities disappeared. This would have possibly profound corporate-governance implications.

In sum, the world of 20 years ago fell far short of the extent of cross-border holdings that would be welfare maximizing for passive portfolio investors. Today, with a severalfold increase in the foreign ownership of the typical, large established corporations around the world, it still falls well short, but not by as far. The distance that could still be traveled would represent a yet much greater amount of foreign ownership. This section considers trends in the factors that favor globalization and in the counter-factors that resist it. An examination of these factors and their trends both helps to explain the increase in foreign ownership that has occurred so far and predicts a substantial further increase in the future.

3.1 Factors Favoring Greater Foreign Ownership

Two factors push investors to hold shares of foreign issuers. First, when investors from a country rich in savings relative to its real investment opportunities are net positive purchasers of securities sold by issuers or persons from a country poorer in savings relative to such opportunities, savings are reallocated from the savings-rich country to the savings-poor one. This profits the residents of both countries. Second, when an investor holds a portfolio that is diversified across issuers of multiple countries, instead of across just the issuers of her own country, she can reduce the risk of the portfolio relative to its expected return and thereby increase the expected utility from her investment activities.

3.1.1 Returns to a Reallocation of Savings

One factor working in favor of foreign ownership is the existence of differences among nations in their amounts of domestically generated savings relative to the quality of the available opportunities for domestic real investment.¹⁴ Real investment opportunities in each nation display diminishing marginal returns in the sense that the proposed projects that constitute any given nation's set of domestic real investment opportunities are bound to have differing earnings prospects and, if the projects are implemented down the list in rank order of their prospects, the more of a nation's projects that are implemented—i.e. the greater the amount of total domestic real investment—the lower the expected return on the marginal project.

p. 789 The amounts of available domestic savings and the sets of domestically available real investment projects have not historically been, and are not likely in the future to be, distributed among nations exactly in the same proportions. In other words, if there were no transnational investment, so that each nation simply took all of its savings and invested them in just its projects, the expected return on the marginal project of each nation would be unlikely to be exactly the same. For example, if Country A's marginal project would have, in the absence of transnational investment, an expected rate of return (say 8%) that is lower than Country B's marginal project would have been (say 10%), Country A can be said to have more savings relative to the quality of its investment opportunities than Country B. A reallocation of savings for investment from A to B will reduce the number of projects implemented in A and increase the number of projects implemented in B. This reallocation enhances global economic efficiency because the projects that are now left unimplemented in A have a lower expected return than the resulting additional ones that are implemented in B. Until such point that any further a shift of funds from A to B will no longer have this result, there will be incentives for persons with savings in A to invest them in B rather than A because they can get a higher expected return.

One of the ways that such a transnational reallocation of savings can occur is when an investor in one country purchases shares in a primary offering of shares issued by an issuer in another country. Further, when, on a net basis, investors in one country make secondary market purchases of securities from investors in a second country, this will have the same effect, and often the securities so purchased will be of issuers from the second country. There are other ways through which such savings reallocations occur, such as internal financial flows of multinational corporations engaging in direct investments, bank lending, private block purchases of securities, and even purchases of government debt. However, the purchase of shares that will be, or already are, publicly traded has the advantages of being an investment that is liquid and that facilitates diversification.

3.1.2 Greater Diversification

A share's future return is probabilistic, not certain, and so each stock has a certain riskiness associated with it. Global investing offers investors a more effective way of reducing the negative impact of this riskiness on their welfare than does exclusively domestic investing. To understand why requires a brief diversion into the theory of portfolio choice, which is a pillar of the modern approach to finance.

p. 790 Portfolio choice theory teaches the investor to focus on what the acquisition of a given security does to the returns on his whole portfolio of securities, not on the security's characteristics in isolation.¹⁵ The critical lesson of portfolio choice theory is that holding a diversified set of risky securities results in lower risk for any given level of expected return.¹⁶ The expected return of a portfolio is the aggregate of the expected returns of its individual securities. The variance of a portfolio is not, however, the aggregate of the variances of its individual securities. This is because of the likelihood that the actual returns of some of the securities will exceed their expected returns and the actual returns of others will fall short of their expected returns. Consequently, the deviations of the two groups will, to one extent or another, cancel each other out, which reduces the amount by which the actual return of the portfolio as a whole deviates from its expected return. By diversifying in accordance with the dictates of portfolio theory, the investor maximizes, for any given level of portfolio expected return, the extent to which this type of canceling out is likely to occur.

There are limits, however, to the effectiveness of diversification for lowering risk. This is most easily seen in terms of a simplified model of portfolio choice theory that focuses on the correlation between the return on each individual risky security and the return on the market of securities as a whole (rather than with each other individual security).¹⁷ Each security has two kinds of riskiness associated with it: unsystematic risk (the portion of the security's variance that has a 0 correlation with the market) and systematic risk (the portion of its variance that is perfectly correlated with the market). Unsystematic risk is due to factors specific in their effects to the issuer or its industry, for example, uncertainty concerning the quality of an issuer's management. Systematic risk is due to factors affecting all issuers whose securities are traded in the market, for example, uncertainty concerning future interest rates. The contribution of the unsystematic risk of individual securities to a portfolio's overall risk can essentially be fully eliminated by sufficient diversification. This is because the deviations of the individual securities are unrelated to each other and will cancel each other out. The systematic risk of the individual securities, however, cannot be eliminated by diversification. To the extent that individual securities deviate from their expected returns due to factors causing systematic risk, generally all securities deviate in the same direction.

p. 791 With this background, one can easily see why global investing offers an investor an opportunity to construct a portfolio with lower risk for any given level of expected return. The extent to which diversification can eliminate overall portfolio risk depends on the proportion of each security's total variance that results from unsystematic risk. This again is because unsystematic risk can be diversified away, but systematic risk cannot. The less each issuer in a market shares in common with the others, the smaller the proportion of systematic risk and the higher the proportion of unsystematic risk. Issuers worldwide share less in common with each other on average than issuers of a given country share in common with each other. Thus, if the relevant securities market is global rather than merely domestic, a larger proportion of each issuer's variance will constitute unsystematic risk and diversification will reduce portfolio risk more.

The concern with diversification highlights the fact that capital markets not only decide which proposed real investment projects should be implemented, but also who will bear the risk resulting from uncertainty concerning projects' future returns. This observation suggests two modifications of the simple model that views transnational investment simply as reallocation of savings. First, the desirability of a given project now depends not only on its expected return but also on its risk characteristics. Second, if all investors were to diversify globally sufficiently to achieve the maximum reduction in risk, the level of each investor's cross-border holdings as a proportion of all her holdings would be determined, not by the amount of savings reallocated transnationally, but by the investor's desire to eliminate unnecessary risk through diversification. If one nation consistently has more savings relative to its real investment opportunities than another, its investors would accumulate a larger absolute share of the joint pool of securities of the two nations.¹⁸ But for investors in each country, the proportions of the securities of the two countries held in their portfolios would be the same and would depend on the respective total market capitalization of the issuers of each.¹⁹

3.2 Non-Corporate-governance Factors Impeding Global Securities Markets

We will now consider the factors independent of corporate governance that play major roles in why investors in fact fall so far short of being fully diversified globally.

3.2.1 Specialized Information Concentrated Nationally

Finance theorists often assume that all investors share identical beliefs concerning the probability distribution of the future returns of the available securities. This assumption is useful for understanding certain aspects of investor behavior. For example, it permits the demonstration that a totally passive investor, who in fact has no specific information concerning the future prospects of the available securities, can minimize risk for any given expected return by simply randomly choosing a sufficiently large number of different securities from all the securities available in the market.

In reality, however, investors in different countries still possess significantly different bodies of information. The assumption of identical beliefs in the face of this obvious reality obscures two other aspects of investor behavior that have been important contributors to a strong home bias in the holdings of securities. First, for the totally passive investor to be willing to undertake the strategy of randomly choosing securities, she needs a basic faith in the market pricing of the securities from which she makes her selection. This faith arises from a level of familiarity which, for many investors, is today still attained only for their particular domestic market.²⁰ Second, some investors (“speculators”) choose their portfolios on the basis of their own beliefs, not randomly, and these beliefs in turn are based on specialized information not possessed by all participants.²¹ Speculators are likely to do better concentrating their buying and selling in equities of issuers about which they and their advisers start with natural information advantages.²² These are likely to be domestic issuers, because the futures of most issuers are determined more by forces occurring within the borders of their own respective countries than by forces occurring outside.

For several reasons, historically, residents of a given nation have had advantages over foreigners in gaining specialized information about forces acting within their own nation. To start, the costs of simply acquiring bits of local information have been lower for a resident, whether that be through timely purchasing of published materials (in, or translated into, a language readable by the recipient) or computerized data, engaging in telephone conversations, or traveling in order to engage in face-to-face conversations or to make on-site physical observations. Thus it has traditionally been far easier for residents to gather a larger number of bits of information at a reasonable expenditure.

More importantly, these same economies that have permitted residents to receive large numbers of such bits of, permit them as well to develop refined rules for evaluating these bits of information: to choose which bits to analyze seriously and by which to be influenced.²³ This evaluation must be based both on the source of the information as well as on its content. The concern with the source goes to the accuracy of the information. It asks the questions, “How trustworthy is the source?” and, assuming that the information has an interpretative element, “How competent is the source?” The concern with content asks the question, “How much does the bit, even assuming the information conveyed is accurate, tell the recipient about whether a particular security is underpriced or overpriced?”

Moreover, the resident recipient, through his education and his continuous absorption of general information concerning his nation, has started with a much richer context in which to make these evaluations. He has also obtain, cheaply, much more concerning both the structure of the source’s motivations and the reputation of the source (i.e., the experience of others with the source concerning his trustworthiness and competence). Since the source has been less expensive to acquire information from generally, the resident recipient is also more likely to have had prior personal experience with the source and hence to have had more feedback on the quality of information the source provides.²⁴ The resident recipient is, for the same reasons, more likely to have had prior experience with the usefulness of bits with any particular content when the information involved relates to local forces. For many of the same reasons, he is also more familiar with the institutions involved in the process of price formation for his own nation’s issuers.

Technological change, of course, has been a game changer in this story. It can help explain the severalfold increases in the proportion of cross-border holdings in investor portfolios. It also forecasts further increases to come. Over the last 20 years, technological change has substantially narrowed, and in many cases eliminated, the differences in the respective costs of timely acquisition of information from foreign

and domestic sources. Consider email, transmission of documents by email attachment, the web, links to computerized databases, all of which have no cost sensitivity to distance, and international telephone calls and travel for face-to-face meetings and on-site inspections, each of which has declined greatly in cost. This reduction in the difference between acquiring information domestically and from abroad applies with respect to both information directly relevant to predicting the prospects of issuers and information about the motivations and reputation of the sources of such directly relevant information. These same technological changes have also contributed to the development of truly transnational securities firms with the trust and control advantages of communications within a single organization. Finally, these technological changes, through their effect on mass media, marketing, education, scholarly research and direct personal interaction, are working toward creating a more uniform social and economic culture among the capitalist nations of the world and the coalescence around English as the international language. This greater uniformity of culture and language assists the speculative investor in evaluating the information he receives from abroad and gives the passive investor more faith in how stocks of foreign issuers are priced. Moreover, the rules by which investors and their advisers evaluate information have a “learning by doing” aspect and improve with experience, so that even the decline in information costs to date has not yet had anywhere near its full impact on reducing the impediment to global securities markets traditionally arising from the cost advantages of local information.

3.2.2 Currency Exchange Risks

If the resident of one nation, for example the United States, purchases a security of an issuer of another nation, for example the United Kingdom, the investor must consider the possibility that when he converts the return back into dollars, the rate of exchange may be different than at the time of the purchase. Thus, to the United States investor, the UK security has an additional element of risk—an additional source of variability of return—that would not be present with an otherwise identical United States security. With holdings of foreign securities from a diversified set of nations, the variations in return of individual securities caused by exchange rate fluctuations would tend to cancel each other out. There is still remaining risk, however, that comes from the extent to which the investor’s home currency’s value has changed relative to a basket made up of the currencies of the other nations of the world. This is a risk that will discourage cross-border stock holdings.

Two factors moderate this risk, changes in each of which have contributed at least slightly to the increase in cross-border holdings over the past two decades. One factor comes from the fact that an increasing portion of the goods and services consumed by the typical investor comes from abroad. For example, from 1993 to 2012, the percentage of goods and services imported from abroad increased from 10% to 17% for the United States, from 16% to 24% for China, from 7% to 17% for Japan, and from 26% to 34% for the United Kingdom.²⁵ Future fluctuations in currency exchange rates create risks concerning how much of these foreign goods and services the investor will be able to consume when, in the future, she liquidates her investments to consume. Holding foreign issuer securities is a hedge against this risk. In domestic currency terms, exchange rate fluctuation will affect the return on foreign securities and the cost of imported goods in the same direction. Since one is income and the other expenditure, the effects tend to compensate for each other. With the increase in international trade, there is more room for holdings of foreign securities to act as a hedge, thereby reducing an investor’s overall risk from exchange rate fluctuations, rather than adding to it.

The other factor is the ability to use currency futures to hedge against the effect of future exchange rate changes on the returns of foreign securities. Futures markets for securities have become less expensive to use and allow for longer-term hedges than was the case a few decades ago.

3.2.3 Government Impediments to Transnational Investments

Governments can impede transnational securities transactions through currency controls and taxes and through securities regulation.

Consider a potential transnational transaction involving an issuer or secondary seller of one nation and an investor of another. The government of either nation can have tax or currency exchange regulations that create sufficient disincentives such that the transaction does not take place. The government of the investor, for example, may make it difficult or impossible to obtain the foreign currency with which to purchase the security, may tax the returns on foreign securities at a higher rate than it taxes the returns on domestic securities, or may refuse to grant the domestic holder of a foreign security a tax credit for taxes withheld from the returns by the government of the issuer. The government of the issuer may make it difficult or impossible for a foreign investor to turn returns paid in the local currency of the issuer's nation into the investor's domestic currency. Alternatively, it may impose a withholding tax on the returns which, for a number of possible reasons, may not reduce the investor's home tax obligations by a commensurate amount. Transnational transactions can be discouraged not only by currently existing regulations of these sorts, but also by the fear that they might be imposed at any point in the future during the life of the security.

The period after World War II witnessed a variety of such currency control and tax measures imposed by many of the world's most advanced economies. These measures tended to reinforce segmentation of securities markets along national lines. The countries involved had largely dismantled these measures by the end of the 1980s, however. A return of such measures in these advanced economies is unlikely because such nations compete with each other to provide environments congenial to the financial services industry, which regards such taxes and regulations as anathema.

Because of the rise of the emerging market countries as significant players in the world economy, however, such measures still play an important role impeding cross-border equity ownership. Many of these countries, most notably China, continue to impose such controls. There is much talk of liberalization concerning these countries, which would lead to a further weakening of this impediment to foreign ownership. For many of these countries, it is unclear, however, whether this talk will materialize into action. Among other reasons, they may hesitate because of the experiences of some emerging countries that have lifted such controls, which have then been subject to fluctuating capital flows. These fluctuations have accentuated upswings and downswings in their overall economies, leading to cycles of boom and bust. While equities, which have no fixed repayments, presumably contribute less to this boom-and-bust problem than do short-term fixed repayment securities, they may still play some role and in any event may still be subject to the same blanket restrictions that apply to all other capital market instruments.

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3.2.3.2 Securities Regulation

There cannot be foreign ownership without transnational transactions. These transnational transactions in turn inevitably give rise to potential regulatory claims by multiple countries. When more than one country in fact imposes its regulations on an activity associated with a transnational securities transaction, the transaction becomes more expensive to undertake, thereby creating an impediment to a global market for the issuer's shares.

To see how such impediments can arise, we will review some US regulations and legal actions and consider their application to the shares of established foreign firms that are efficiently priced in trading markets abroad. Section 5 of the Securities Act of 1933 (the "Securities Act") prohibits the offer or sale of any security by any person unless the security is registered under the Act. Such registration requires a complex process of disclosure. The SEC has always been clear that it interprets Section 5 as covering public offerings made in the United States by foreign issuers. Further, any foreign issuer wishing its securities to be listed on a US stock exchange must, just like a US issuer, register these securities with the SEC pursuant to Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act"), which again involves a complex process of disclosure. This registration automatically makes the issuer subject to the Exchange Act's periodic disclosure regime,²⁶ as does the registration of a public offering under the Securities Act.²⁷ This disclosure regime is generally regarded to be as strict as that of any country in the world.

Listing on a US exchange can also create the potential for a foreign issuer to be liable for large damages payments as the result of a fraud-on-the-market class action.²⁸ This kind of private action allows secondary market purchasers, who suffer losses because the price they paid was inflated by an issuer's misstatement made in violation of Exchange Act §10(b) and Rule 10b-5, to recover as a group their total damages. These actions give rise to the bulk of all the damages paid out in settlements and judgments

pursuant to private litigation under the US securities laws and are what gives the United States the reputation in the rest of the world of being the securities damage action “Wild West.”²⁹ No other country has a civil liability provision that regularly imposes a similar level of damages on issuers.

p. 797 As discussed above, technological advances have substantially reduced the costs for US investors to acquire information about, and to evaluate, foreign issuers relative to the costs they face doing the same with respect to comparable US issuers, especially large established foreign issuers trading in efficient markets abroad. The US decision to apply these regulations and causes of action to foreign issuers creates costs on an expected basis that would not be present if the issuer were subject only to its home country’s laws with respect to the activities involved. These expected costs lead some foreign issuers to avoid offering, or promoting the trading of, their shares in the United States. As a result, there are situations in which a public offering to US residents would provide a foreign issuer with the lowest cost of capital, but the offer is not made. Similarly, there are situations where a United States trading venue would offer the best liquidity services, relative to cost, for the trading of the issuer’s shares but the issuer does not list or otherwise promote trading there. US investors suffer from these lost transactions as well. Because the issuer’s securities are not conveniently available in the US primary or secondary trading markets, US investors face barriers to enjoying the risk-reduction benefits from full international diversification.³⁰

The traditional rationale of the US decision to apply these regulations and causes of action to foreign issuers has been to protect US investors and markets.³¹ I have argued elsewhere that in the case of foreign issuers trading in efficient markets abroad, such US application is not necessary to protect US investors against investing at unfair prices. This is because, if these US laws and causes of action were not applied to these foreign issuers, prices would be appropriately discounted to reflect this fact.³² Rather, regulations and causes of actions of this type serve corporate governance and liquidity enhancement functions. These regulations have costs and benefits that depend on their intensity. The optimal level of regulatory intensity varies from one country’s issuers to those of another. The benefits of getting the level of regulatory intensity right redound mostly to the issuer’s home country, which thus has the greatest incentive to do so. Accordingly, the impediments to global trading arising from the US application of these regulations and causes of action to foreign issuers are needless from both a US and a global economic welfare point of view.

Perhaps in growing recognition of the costs associated with impeding global trading, the United States has in recent decades been pulling back. Since the early 1980s, foreign issuers have not been required to disclose as much in either their public offering or in their ongoing periodic reports as US issuers are required to disclose, whereas previously they were.³³ More recently, the SEC decided to permit foreign issuers to report their financials in their US filings in accordance with International Financial Reporting Standards (“IFRS”), which many foreign issuers use to satisfy their home country requirements, whereas previously such financials needed to be reconciled with US GAAP.³⁴ Finally, in *Morrison v. Nat’l Austl. Bank*,³⁵ the US Supreme Court concluded in 2010 that Exchange Act §10(b)—and hence fraud-on-the-market actions—reached only situations where the securities were listed on a US exchange or where their purchase or sale was effected in the United States.³⁶ For most foreign issuers, this means that any need to pay fraud-on-the-market damages or settlements would be confined to only the portion of the foreign firm’s shares that are purchased in US trading, whereas previous lower-court decisions created possible liability to purchasers worldwide.³⁷

There are likely to be further reductions in these US impediments in the future. Consider what would happen if the United States were to maintain them at their current level. The global integration of equity markets outside the United States would continue to progress. This integrating market outside the United States would improve the non-US options available to foreign issuers. Fewer and fewer foreign issuers would find that the benefits of offering their shares in the United States, or promoting US trading of their shares, would be worth the costs. US capital markets would be left mostly with only US issuers,³⁸ while competing markets abroad would have the opportunity to be the trading venues for all the rest of the world’s issuers. Thus, the level of activity in the US capital markets would fall further and further short of what it could be, and with it the skill-based rents earned by the US residents employed by enterprises associated with these markets. This prospect is likely to lead to increasing political pressure to reduce these US impediments, an effort that is particularly likely to succeed given, in my view, their lack of any real value in protecting US investors or markets.

3.2.4 Transaction Costs of Acquiring Foreign Securities

p. 799

A final factor impeding foreign ownership of a corporation's shares are the extra costs associated with the transactions by which foreign investors acquire its shares. Two kinds of transactions can result in share ownership by foreign investors. One is a purchase by the foreign investor on an exchange in the issuer's home country, or in an offering being conducted in the issuer's country. Such a transnational transaction involves the additional costs associated with international communications, currency exchange, and clearances and settlements that are not present with transactions occurring at home. The other kind of transaction is a purchase by the foreign investor on an exchange in the investor's home country, or in an offering being conducted in that country. This avoids the costs to the investor of a transnational transaction, but it imposes on the issuer the additional costs of maintaining an exchange listing in the investor's home country or conducting an offering there.

The same technological changes that have been narrowing the cost differential of obtaining information from foreign and from domestic sources have been greatly reducing differences in real resource costs between executing a purchase on a domestic exchange, or in a domestic offering, and making these purchases abroad. This is particularly true of secondary trading. It also has become much more practical for the major exchanges around the world to compete for listings from foreign issuers and orders from foreign traders. Share-trading venues in the advanced economies have all become electronic limit-order books, where a computer matches electronically posted limit orders with electronically submitted incoming marketable orders. It is essentially as easy and inexpensive to post a limit order or submit a marketable order from a country distant from the venue as from within the same city as the venue. The only remaining impediment to each of these venues serving a truly global market (other than that, as discussed above, posed by national securities regulation systems) is the need to perfect a seamless transnational system of clearance and settlement.

4 The Interaction of Foreign Ownership and Corporate Governance

As many of the other chapters in this book make clear, what constitutes good corporate governance is a matter of considerable contention. This chapter will not wade deeply into this fight. Rather it focuses on one dimension of an issuer's corporate governance: its capacity to support portfolio investment, i.e., to support a shareholding base that includes a substantial portion of the issuer's shares held by persons who individually do not hold enough to exert control and who are numerous enough that it would be difficult to form a group to exercise control.

This choice to focus on portfolio supportive corporate governance is made for positive, not normative, reasons. Most publicly traded firms outside the United States and the United Kingdom have control shareholders. Control shareholders in turn are most often of the same nationality as the issuer. These control shareholders might sell a block of shares to a foreign holder, but the relationship thereafter between the control shareholders and the foreign block holder is likely to be governed by a contract specific to the particular transaction. Thus, for there to be some kind of more general relationship between foreign share ownership and corporate governance, this will arise out of a situation where the foreign holders are portfolio investors, i.e., holders of freely trading non-control shares. A firm's potential for having foreign portfolio investors depends on its potential for having portfolio investors more generally, which, in turn, depends on the portfolio supportiveness of its corporate governance.

p. 800

This section begins with an elaboration of the concept of portfolio-supportive corporate governance and its implications. Subsequently, we review the literature suggesting that improved corporate governance in fact does lead to greater foreign ownership. Finally, we review the literature suggesting that increased foreign ownership leads to improved corporate governance. In each case, the review will consider the catalytic role played by the weakening of the non-corporate-governance impediments to foreign ownership discussed in section 3.

4.1 Portfolio-Supportive Corporate Governance

In an efficient market, the market price for an issuer's shares reflects an unbiased prediction of the cash flows to be received by the holder. Thus, the price of a stock trading in such a market should fully discount for the extent to which some feature of an issuer's corporate governance reduces this expected cash flow. At first take, this observation would appear to suggest an issuer's corporate governance should have no effect on the extent of foreign ownership. For an issuer with poor corporate governance, the market would expect the portfolio holder of its shares to receive a lower future cash flow discounted to present value than would be expected of an issuer with good governance. Thus the share price of the poor governance issuer would be commensurately less than that of the good governance issuer. As a consequence, this reasoning would go, the share of the poor governance issuer is an equally attractive purchase: the lower price would make up for its lower value.

This first take on the problem, however, ignores a fundamental precondition. A firm will never have portfolio investors of any kind—foreign or domestic—unless these initial control shareholders decide to sell some of their shares to such investors, or to direct the firm to issue and sell shares to such investors. Someone has to start a firm and so all firms inevitably start out their existence with only control shareholders and no portfolio shareholders. The control shareholders will not make the decision to effect a transaction that results in portfolio shareholders unless the portfolio investors are willing to pay a share price sufficiently high that controlling shareholders find the transaction to be worthwhile. Thus, to determine a firm's potential for having portfolio shareholders, we need to examine what portfolio investors are willing to pay and how this interacts with what control shareholders would think is a sufficiently high price to make a sale to the portfolio investors worthwhile.

4.1.1 The Problem of Information Asymmetries

As just noted, the value of an issuer's shares to portfolio investors is determined by the discounted present value of the distributions, including dividends, that the portfolio holder of each such share can expect to receive in the future. The value of these distributions in turn depends in important part on the extent to which the issuer's future discounted-to-present-value net cash flow is expected to be diverted to benefit just the control shareholders. Such a diversion can occur in either of two ways. In one, the firm's assets are deployed in a way that would maximize the value of their expected future cash flow, but the control shareholders give to themselves a greater than pro rata distribution of cash, or obtain the equivalent amount of cash by directly or indirectly entering into a contract with the firm on terms more favorable to them than market terms. The other way involves the control shareholders operating the firm in a way that benefits them, but does not maximize the discounted-to-present-value expected future cash flows of the firm.³⁹

p. 801 A sale to portfolio investors by a firm's control shareholders, or by the firm they control, will only be worthwhile to the control shareholders if the price that the portfolio investors are willing to pay is greater than the control shareholders believe, based on what they know, to be the value to them of simply retaining their ownership position as it is. The prospect of diversions by a firm's control shareholders would not affect this calculation, however, if, unlike the real world, the control shareholders and portfolio investors were equally well informed as to what size the diversions will be. Larger expected diversions would mean that control shareholders would enjoy more in the way of the private benefits of control in the future, but they would pay for this benefit now in terms of a commensurately lower price for the shares sold to portfolio investors. The fundamental problem is that control shareholders are in fact better informed about the expected size of these future diversions than portfolio investors.

This asymmetry of information creates a classic "lemons" situation. Consider two types of issuers. The first type has "high-quality" shares. Based on the better information possessed by the controlling shareholders of these high-quality issuers, the expected value of the distributions of these shares is high because they plan to engage in little or no diversion. The second type of issuer has "low-quality" shares. Based on the better information possessed by the controlling shareholders of these low quality issuers, the expected value of the distributions of these shares is low because the planned diversions by these issuers' control shareholders are large. Because the portfolio investors have less information, they are unable to distinguish between the two types of shares.

As George Akerlof showed in his classic 1970 article concerning adverse selection, if nothing alters this asymmetric information situation, the low-quality version of any item of sale can drive the high-quality version out of the market.⁴⁰ Suppose, in our example, that potentially there were an equal number of high-quality and low-quality shares offered in the market. Given that buyers cannot distinguish between what in fact are the high-quality shares and the low-quality ones, the price they rationally will be willing to pay will be the same for all the shares: the average of the expected values of the high-quality shares and the low-quality shares. This is because there would be a 50% chance a purchased share was from a high-quality issuer and a 50% chance that it is from a low-quality issuer. This result would not be an equilibrium solution, however. The blended price that portfolio investors are willing to pay may well not make a sale worthwhile for the controlling shareholders of the high-quality share issuers. If so, the controlling shareholders of the high-quality issuers would decide not to offer their shares at all. The potential portfolio investors would then know that only the low-quality shares would be available and the shares would be priced in the market accordingly.

Now imagine a range of issuers in terms of their share qualities, with the worst, because of some mix of poor expected underlying cash flow and diversions by control shareholders, that are worth nothing. The highest-quality issuers, as just described, would not enter the market in the first place. Now the next-highest-quality issuers would be in the same position as the highest-quality issuers would have been if they had stayed in the market. This is because the price offered to them would be an average of the expected value of these next-highest-quality shares and the values of the shares of all the lower-quality issuers. So now these next-highest-quality issuers would not enter the market. Moving down the list in terms of the quality of an issuer's shares, this story can be repeated again and again. In the end, the market unravels completely and there are no share offerings to portfolio investors.

4.1.2 The Incentives for Control Shareholders to Create Portfolio Holders

If this information asymmetry problem can be solved, however, the control shareholders of a firm have a number of motives for selling to, or causing the firm to sell to, portfolio investors. To start, when the control shareholders are the sellers, they are able to diversify their investment portfolios by taking the cash received from the sales and investing it elsewhere. By doing so, they can have a reduced level of risk for any given level of expected return, as discussed earlier. Further, the existence of an active trading market in the shares of the firm makes the remainder of their holdings more liquid, especially when sold in small chunks. Finally, the prices of the firm's shares in an efficient secondary trading market can serve as useful guides to the firm's management. A firm's managers ordinarily know more about what is going on within the firm than does anyone else, but they are not so expert relative to others with respect to many features of the outside environment within which the firm operates. Prices in an efficient market very usefully incorporate all publicly available public information concerning these features of the outside environment. Thus market prices incorporate better predictions of the effects of these features of the outside environment on the firm's future cash flows than the parallel predictions of the managers.

4.1.3 Overcoming Information Asymmetry Problems and the Role of Corporate Governance

A number of market-based antidotes to the information asymmetry problem allow some sales to portfolio investors to occur that would otherwise be blocked by the asymmetry problems described above.⁴¹ Each of these market-based antidotes to the information asymmetry problem has significant limitations, however.⁴² Mandatory disclosure law can supplement these market-based antidotes and allow more such sales to occur. So too can improved corporate governance, which is key to the theoretical story of how corporate governance can affect the level of foreign ownership.

4.1.3.1 Market-Based Antidotes to the Information Asymmetry Problem

The high-quality issuers, in our example above, may be able to credibly "signal" facts demonstrating their quality. This is so, however, only if making a false claim as to quality would not be worthwhile to the controlling shareholders of any issuer that is not high quality because of legal liability or loss of reputation. To avoid these costs, the low-quality issuers would remain silent rather than falsely claiming facts suggesting that they are high quality. The market then would infer from their silence that they are low quality.⁴³

A high-quality issuer can also sell its shares to an investment bank that then resells them to portfolio investors at a premium that investors are willing to pay because of the bank's involvement. The bank will be able to sell the shares at this premium price if the bank has the capacity to distinguish between high- and low-quality issuers and has a reputation for honesty that the bank, as a repeat player, finds it worthwhile to retain.⁴⁴

To the extent that the quality of an issuer can be demonstrated by accounting information concerning assets, liabilities, and financial performance to date, a high-quality issuer can also distinguish itself by having its accounts certified by an outside accounting firm with a reputation worth preserving.⁴⁵

4.1.3.2 Mandatory Issuer Disclosure at the Time of an Offering to Portfolio Investors

Effective mandatory disclosure at the time of a public offering of shares can address aspects of the asymmetry directly and, because each of the market-based solutions has limitations, allows additional sales to portfolio investors that the asymmetry problem would otherwise block if only the market-based antidotes were available. Truthful information about an issuer's prior history of diversions, and about the histories of the control shareholders in connection with other business ventures, will narrow the gap between control shareholders and portfolio investors in terms of their respective abilities to predict the level of future diversions.⁴⁶

p. 804 **4.1.3.3 Corporate Governance**

In this information asymmetry story, corporate governance is also relevant to the level of portfolio investor ownership and hence the possibility of foreign portfolio investor ownership. A principal focus of corporate law is the prevention of diversions. Much of modern corporate law has been built around this goal. The goal is reflected not only in rules requiring that dividends and distributions be made pro rata, but also in the basic fiduciary rules policing non-arm's-length transactions involving insiders and the corporation.⁴⁷ The more limited the possible extent of such diversions, the less important is the existence of information asymmetry between the controlling shareholders and portfolio investors concerning what the actual expected level of diversion will be. The information advantages of the controlling shareholders as to the expected extent of diversions will matter less since the maximum possible amount of diversion is less. The less important the asymmetry, the fewer stock sales are blocked that would have occurred absent the asymmetry.

The prospect that an issuer will be subject to an effective ongoing mandatory issuer disclosure regime—a regime that requires an issuer to regularly update its disclosures—can also reinforce the constraints that corporate law and reputational concerns put on diversions. Diversions are less likely to occur if control shareholders know that the diversions will subsequently become publicly known.⁴⁸ There is a general recognition that transparency is necessary for good corporate governance.⁴⁹

These restraints on diversions arising from corporate law and from an effective ongoing periodic disclosure regime are especially important in the case of an issuer with no existing portfolio investors and whose controlling shareholders do not have significant involvement in prior business ventures. With such an issuer, disclosure at the time of the offering will do little to reduce the information asymmetry between the control shareholders and potential investors concerning the expected extent of future diversions. The conclusion that these diversion constraints are especially important for IPOs of first-time entrepreneurs should be highlighted because a public market for issuers of this kind is important for the dynamism of an economy,⁵⁰ which can contribute to economic growth even for emerging countries.

In sum, corporations inevitably start their lives with control shareholders. For most countries of the world, control shareholding is the preponderant ownership structure even for their older, larger firms.⁵¹ In many such firms, the control shareholders would enter into, or direct their firms to enter into, transactions that would result in a larger portion of the firm's shares being held by portfolio investors if it were not for adverse selection's negative effect on what potential offerees would be willing to pay. Subjecting the firm to more effective corporate law constraints on diversions by control shareholders reduces this impediment to greater portfolio holdings. So does subjecting the firm to a more effective ongoing periodic disclosure regime. Thus, where one or both of these diversion reduction constraints are mandatorily imposed on the firm pursuant to its home country's legal system, or where a firm is otherwise individually subjected to one or both of these constraints, we would expect, all else equal, that a greater portion of the firm's shares would be held by portfolio investors.

The remainder of this chapter will refer to both corporate law constraints on diversions and obligations to provide ongoing disclosure as "diversion constraints." This terminology will be used whether the constraint or obligation is imposed by a firm's home country's laws or by the firm's individual actions. The expression "more effective diversion constraints" will be applied to the situation where the rules constituting a diversion constraint stay the same but are enforced in such a way that the frequency of compliance is increased. It will also be applied to the situation where the rules constituting a diversion constraint are tightened but the frequency of compliance with new rules is not any greater than the frequency of compliance had been with the old, laxer rules.

4.2 More Effective Diversion Constraints Leading to Greater Foreign Ownership

There is a strong argument, based on a growing empirical literature, that being subject to more effective diversion constraints leads on average to a greater portion of a firm's shares being held by foreign investors. As elaborated below, this argument suggests that the continued lessening of the non-corporate-governance impediments to global shareholding is acting as a catalyst that is resulting both in increasing foreign ownership and in firms around the world being subject to increasingly effective diversion constraints.

4.2.1 Implications from the Discussion of Portfolio Supportive Corporate Governance

In the preceding discussion, we concluded that firms with more effective diversion constraints can be expected to have a higher proportion of their shares on average held by portfolio investors. This conclusion gives rise to two important implications.

p. 806 First, the weakening of the non-corporate-governance impediments to foreign ownership discussed in section 3 increases the pool of the firm's potential portfolio investors. As a result, more situations arise where, absent the impediments created by adverse selection, both the firm's control shareholders and portfolio investors would find advantageous a transaction that increases the portion of the firm's shares held by portfolio investors. For any firm where this is the case, its control shareholders would, with the weakening of these impediments, have the incentive to adopt more effective diversion constraints. Using the same logic, a country with a relatively poor-quality corporate law or mandatory ongoing securities disclosure regime would have incentives to strengthen each. Individual firms, and countries as a whole, tend to respond to incentives.⁵² When they respond to these incentives for more effective diversion constraints, the portions of firms' shares held by portfolio investors, including in particular those of foreign portfolio investors, should increase.

Second, some countries that start with a relatively ineffective corporate law or mandatory ongoing periodic disclosure regime will decide to strengthen their corporate law or disclosure rules for reasons independent of the weakening of the non-corporate-governance-related factors impeding global markets that is discussed in section 3.⁵³ With the weakening of these impediments, however, this strengthening of the country's corporate or securities disclosure laws will lead to a greater increase in the proportion of shares held by foreigners in the country's firms than would have occurred otherwise.

p. 807 Keeping in mind these two implications, we can now move on to consider what the existing empirical literature suggests about whether more effective diversion constraints in fact lead to increased foreign

ownership and the role played in this process by the weakening of the non-corporate-governance-based impediments to the global markets for equities.

4.2.2 Strong Effective Domestic Corporation and Securities Disclosure Laws and the Size and Depth of Capital Markets

There is evidence that countries with stronger corporate-governance rules and enforcement have substantially larger equity markets as a proportion of their GDPs and more listed firms.⁵⁴ A large, deep capital market relative to a country's GDP suggests that more of its economy is composed of firms with a significant portion of their shares held by portfolio investors. Thus, this evidence suggests a link between the effectiveness of a country's diversion constraints and the proportion of its firms' shares held by portfolio investors. Even more to the point, there is also evidence that countries with stronger corporate governance have a lower concentration of ownership.⁵⁵ These two kinds of evidence are relevant to the issue under examination—whether more effective diversion constraints lead to greater foreign ownership—because, as we have seen, for a firm to have a significant portion of its shares held by foreign portfolio investors, a precondition is that a significant portion of its shares be held by portfolio investors more generally.

4.2.3 Strong Effective Domestic Corporation and Securities Disclosure Laws and the Extent of Foreign Ownership

Evidence that laws imposing more effective diversion constraints lead to larger, deeper domestic capital markets logically suggests that such laws facilitate greater foreign, as well as domestic, portfolio ownership of a country's firms. There is, however, more direct evidence. The starting point is a substantial body of scholarship showing a correlation between indicators of the effective strength of a country's corporate and securities laws and the extent of foreign ownership of its corporations, a correlation that holds even after controlling for the level of a country's economic development.⁵⁶ Concluding that this correlation is the result of effective laws leading to more foreign ownership, however, requires ruling out that the correlation is instead primarily the result of the reverse causal pathway, i.e., that a larger percentage of foreign shareholders in a country's firms leads to the country adopting more effective diversion-constraining laws. There is a good case for ruling out this possible alternative explanation, however.

As the data at the beginning of this chapter suggests, for most firms in the world, home bias means that at most only a minority of the shareholders of a country's firms are foreign. These foreign shareholders are unlikely on their own initiative to push through legal reforms abroad. As foreigners, they do not tend to wield much influence within the political systems of a firm's home country. Moreover, their stakes tend to be smaller and more disorganized than those of the opposing control shareholders. Thus, it seems unlikely that the correlation between more effective laws constraining diversions and foreign ownership is explained by the foreign owners prompting the legal changes.⁵⁷

4.2.4 The Effectiveness of Individual Firm Diversion Constraints and the Extent of Foreign Ownership

Earlier discussion suggested that being subject to effective home-country corporate and securities laws is only one way for a firm to persuade investors that future diversions will be limited, and thereby resolve the adverse selection problem that impedes ownership of its shares by portfolio investors.⁵⁸ One alternative way would be for the firm to subject itself to one or more of a variety of ongoing transparency enhancing devices. These devices include credibly pledging to comply with a private disclosure code or to obtain certified financials on a periodic basis. They would also include listing on a stock exchange that requires certain ongoing disclosures or that requires registration with a foreign securities disclosure regime that imposes such disclosure requirements on the firm. Another alternative would be to include provisions in the corporate charter that would reduce the chance of diversions.

There is considerable empirical evidence that there is a correlation between such individual firm efforts at good governance and greater foreign ownership.⁵⁹ Again the question arises as to whether this correlation is at least in part the result of good individual firm corporate governance leading to more foreign ownership, or instead is primarily the result of the reverse causal pathway, i.e., that a higher proportion of foreign shareholders leads a firm to adopt better corporate governance. Here we cannot rule out so easily this

second reverse causation explanation. The fact that shareholders are foreign puts them at no particular disadvantage in the individual firm's governance process, unlike their situation with respect to the national political processes of a firm's home country. As discussed below, there is empirical evidence that foreign shareholders do in fact have at least some influence on firm governance.⁶⁰

p. 810 Theory, however, suggests that the correlation would be due at least in part to more effective diversion constraints at the individual firm level leading to greater portfolio share ownership, which presumably would include increased foreign ownership.⁶¹ Fortunately, also, the much larger number of observations allowed by using firm-level data, as compared to using country-level data, permits the use of econometric techniques that can help disentangle the question of causal direction. For example, Covrig, Defond, and Hung, using fixed effects regression techniques, show that foreign ownership increases after a firm switches from local to international accounting standards ("IAS").⁶² Khanna and Palepu reach a similar conclusion in an investigation of the relationship between foreign ownership and measures of transparency of publicly traded firms that are affiliated with business groups.⁶³ Because the affiliated firms in a business group are all controlled by the same owners, they are particularly vulnerable to diversions. These common owners can use their control to have one affiliate, for below-market consideration, enter into a transaction with another affiliate in which the owners have a larger interest, thereby benefiting the owners at the expense of the portfolio shareholders of the first affiliate. Further, due to the possibility of highly frequent non-arm's-length transactions among a group's affiliates, they have a particularly high potential of being non-transparent in their accounts. As evidence that more transparency attracts foreign investors, Khanna and Palepu find that after India, in the early 1990s, lifted a number of provisions that had been preventing or discouraging foreign ownership of shares in Indian corporations, affiliates of business groups that were more transparent displayed a larger gain in their percentages of foreign ownership.⁶⁴

4.2.5 Bonding to Better Governance by an Offering Abroad or Cross-Listing on a Foreign Exchange

A number of scholars have suggested that one way that an individual firm from a country with weak or ineffective corporate-governance laws can impose on itself a stricter regime is to conduct a public offering in, or cross-list on an exchange located in, a country that imposes on the firm the host country's own stricter regime.⁶⁵ Most of this "bonding" literature refers specifically to a public offering or cross-listing in the United States, which is generally believed to have as strict securities disclosure laws as any country. The discussion above suggests that firms that impose on themselves more effective diversion constraints will attract more foreign investors. So, to the extent that such a US offering or cross-listing by a foreign firm really does result in the firm being subject to more effective diversion constraints, the availability of these tools has played a role in the rise in foreign ownership.

How effective, though, is a US public offering or cross-listing as a bonding technique? Answering this question requires both an examination of the theory as to how these actions might work as bonds and a review of the related empirical literature.

p. 811 4.2.5.1 How Bonding Might Work and its Limitations

As discussed above,⁶⁶ any foreign issuer that does a first public offering in the United States or cross-lists its shares on a US exchange is required to file an initial disclosure statement, after which the issuer becomes subject to the Exchange Act's ongoing periodic disclosure obligations.

Several things should be noted at the outset about a US public offering or cross-listing as a bonding device. First, the applicable US securities laws do not impose any obligations on the controlling shareholders of the issuer undertaking the offering or cross-listing to refrain from engaging in diversions. Rather, these acts of bonding work, to extent that they are effective, by the threat of US legal sanctions if the bonding firm misstates facts in its disclosure filings or omits required information. Thus, a controlling shareholder contemplating a diversion would know that if it were to go ahead, it either would need to comply with the disclosure rules intended to reveal such a diversion or face the threat of legal sanctions for non-compliance with these rules.

Second, whether a firm does a public offering in the United States or just cross-lists there, it is the periodic-disclosure obligation that does the main bonding work. The initial Securities Act or Exchange Act filing may help disclose the existence of past diversions and hence, by revealing the character of the control

shareholders, help investors predict the level of future diversions. However, it does nothing to deter future diversions other than to provide baseline information that makes the subsequent periodic disclosures more meaningful.

Third, a US public offering or cross-listing is only effective as a bonding device to the extent that the control shareholders reasonably expect to be hurt if they violate their disclosure obligations. For a number of reasons, most foreign issuers and their managers and control shareholders have considerably less to fear from a violation than do their US counterparts. Many foreign issuers and their managers and control shareholders have little or no presence in the United States and hence, relative to their US counterparts, face much less exposure to the criminal, and even the civil, sanctions arising from a violation of their US disclosure obligations. In addition, there is some evidence that the SEC is unwilling to devote as much in resources to prosecuting cases involving foreign issuers.⁶⁷ Moreover, even the control shareholders of foreign issuers that fully comply with their SEC mandates have less to fear from these mandates because they are not required to disclose as much, or as frequently, as their US counterparts.⁶⁸

p. 812 Finally, the SEC and the US Supreme Court have each taken actions in recent years to reduce the effectiveness of foreign-issuer bonding. In 2007, the SEC promulgated Rule 12h-6, whereby the SEC has provided a means of exiting the periodic disclosure obligations for any foreign issuer whose average trading volume in the United States was less than 5% of its worldwide trading volume.⁶⁹ A large portion of the world's publicly traded issuers would not have this large a US trading volume if they did a US public offering or cross-listed on a US exchange, in which case neither of these acts would constitute any real kind of bond since exit would be easily available soon thereafter. Even where the US trading volume would be greater than 5% immediately after the offering or cross-listing, investors in many cases could not be confident that they would not fall below 5% in the future.

In 2010, in *Morrison v. Nat'l Austl. Bank*,⁷⁰ the Supreme Court concluded that §10(b) reached only situations where the securities were listed on a US exchange or where their purchase or sale was effected in the United States.⁷¹ As discussed, this ruling had a major impact on fraud-on-the-market class actions against foreign issuers.⁷² Under *Morrison*, at least for foreign issuers that do their US equity listing in the form of American Depository Receipts (ADRs), which is the predominant approach, any damages or settlement payments arising from such an action are confined to only the portion of the foreign firm's equity that is purchased in US trading, often only a small fraction of the total, whereas previous lower-court decisions suggested that a firm could sometimes be liable to all purchasers worldwide.⁷³ US issuers, in comparison, continue to be liable to all purchasers who suffer these losses from their purchases. Thus, for the typical foreign firm listed on a US exchange, this civil damages cause of action has a smaller, often much smaller, capacity to deter misstatements.

4.2.5.2 Empirical Evidence that a US Offering or Cross-Listing Constitutes an Effective Bond

A number of studies document that when a foreign firm cross-lists in the United States, its stock price experiences a jump up in price.⁷⁴ Moreover, the weaker the disclosure regime of the firm's home country, the bigger the jump.⁷⁵

p. 813 What, though, causes this price jump? Theory suggests three possibilities, none mutually exclusive. First, cross-listing may lower the rate at which the market discounts the future cash flows expected to be received by shareholders. The discount rate decreases in part because the cross-listing reduces the segmentation between the market of the firm's home country and the US market, enlarging the number of investors that can conveniently trade in its shares with the portfolio risk reduction that transnational investing allows. It also decreases in part because the improved disclosure resulting from the imposition of the US disclosure regime increases the stock's liquidity by reducing market maker's adverse selection concerns. Discounting expected future cash flows at a lower rate increases the present value of the right to receive these cash flows and hence the stock will trade today at a higher price. This is so even if the cross-listing is not expected to change the future behavior of the firm and its control shareholders and hence not expected to increase future cash flows received by the portfolio shareholders.

Second, the price jump may occur because the cross-listing leads the market to expect that the future cash flows received by the firm's portfolio holders will be greater than previously expected because the cross-listing shows the firm's willingness to submit to greater scrutiny its claims of a bright future. In other words, the decision of the control shareholders to cross-list is a signal that makes these claims more

credible and hence leads to an increase in the outside market's perception of the expected level of the firm's future cash flows to portfolio holders. Thus, again, the price would increase even if those who are most knowledgeable do not expect the cross-listing to change the future behavior of the firm and its control shareholders, and hence do not expect an increase in actual cash flows to the portfolio shareholders.

A third possible reason for the price jump is the focus of the larger discussion here, i.e., bonding. This would be the idea that the greater scrutiny of the firm permitted by improved disclosure is expected by the market to change firm and control shareholder behavior in a way that will increase actual future cash flows to the firm's portfolio shareholders.

We can label these three potential explanations, respectively, the discount rate, signaling, and bonding explanations. The prospect of a price jump, whatever the explanation, is presumably an important motivation for a firm to cross-list. Determining, however, whether bonding is playing a significant role in this price jump is tricky because each of three explanations shares with the others either the same driving factors or ones that are at least highly correlated with each other. Disclosure improvement is the driving factor behind both the bonding and signaling explanations as well as behind the liquidity improvement part of the discount-rate explanation. The weaker the home country's disclosure regime, the greater will be the disclosure improvement from cross-listing. The driving factor behind the other part of the discount rate explanation is that the access to the US capital market helps make up for shortcomings in the size and functional quality of the home country's capital market and its lack of integration into the larger global capital market. The greater these home country shortcomings, the more cross-listing can help. The extent to which cross-listing can help in this way is likely highly correlated with the extent to which it improves disclosure. This is because home countries with smaller, more poorly functioning domestic capital markets that are more distinctly separate from the larger global capital market tend also to have weaker disclosure regimes. Thus the driver of this second part of the discount-rate explanation, though not the same as the driver of the other explanations, is highly correlated with it.

p. 814 Some studies suggest that there is at least more at work in the price jump than the capital market improvement part of the discount-rate explanation. Reese and Weisbach, for example, find that firms from weak diversion-constraint countries are more likely to engage in equity offerings after cross-listing in the United States than firms from stronger diversion-constraint countries, yet the offerings tend to occur outside the United States.⁷⁶ This suggests that the price gain from the cross-listing carries over to these offerings in markets without the size and functional quality of those in the United States. Hail and Leuz use changes in analysts' predictions of future cash flows to isolate the typical foreign issuer's US cross-listing's effect on the discount rate from the market's expectations of the firm's future cash flows (which could be the result of the signaling effect, the bonding effect, or both). They find that on average a change in cash flow expectations explains about half the price jump.⁷⁷

While these studies show that there is some effect from the bonding or the signaling effect, they do not allow us to distinguish between the two effects in order to see if the bonding effect in fact plays a role. There is at least some indirect evidence that bonding does play a role, however. Studies by Doidge⁷⁸ and by Bris, Cantale, and Nishiotis⁷⁹ each focus on firms with two classes of stock, where both classes have the same cash flow rights per share, but one class has higher voting rights per share and, as a result, trades at a higher price. Each study finds that the price ratio of the high voting stock to the low voting stock decreases significantly after a US cross-listing.⁸⁰ In each study, the authors attribute the high voting stock's premium at least in part to the ability of the control to engage in diversions and interpret the decline in this premium to the cross-listing imposing new constraints on such diversions.⁸¹ It should be noted that the price for the high voting shares used in the study is of course the price at which the publicly held ones trade. The holders of these shares are not part of a control group that can steer diversions in their direction. However, if the current control group does not have a majority of the share votes, the publicly held high voting shares still have extra value that is related to the ability of control to extract diversions. This is because their holders can sell to someone who is trying to assemble a new control group or who is trying to reinforce the power of an existing one. Lel and Miller focus on the effect of cross-listing on the likelihood that a CEO would be fired in the face of disappointing financial results.⁸² They find that cross-listing increases this likelihood more for firms from weak diversion-constraint countries than from strong ones, suggesting that cross-listing leads to better governance.⁸³

4.2.5.3 Effects of Cross-Listing Independent of its Bonding Effect

p. 815 A US cross-listing, independent of its effectiveness as a bonding device, will tend to promote foreign ownership because it reduces the cost, inconvenience, and regulatory hurdles associated with the purchase by US investors in the cross-listed foreign issuer. As discussed earlier, the availability of US cross-listings could play a larger role in promoting foreign ownership if the United States gave the issuer the option of imposing on itself the Exchange Act's ongoing periodic disclosure obligations, but did not require the issuer to do so. This optional approach would continue to allow firms to use these obligations as a bonding device, but would reduce the cost of cross-listing for firms that do not wish to bond.

4.3 Greater Foreign Ownership Leading to More Effective Diversion Constraints

There is also considerable evidence that a larger portion of a firm's shares being held by foreigners leads to the firm being subject to more effective diversion constraints. This evidence suggests that the continued lessening of the non-corporate-governance impediments to global shareholding is acting as a catalyst in a second way that is resulting in both increasing foreign ownership and better governance around the world.

4.3.1 How Greater Foreign Ownership Could Lead to More Effective Diversion Constraints

As discussed above, it is unlikely that if a country's firms have a larger proportion of foreign owners, there will be pressure on its government to enact and enforce stricter corporate and securities disclosure laws.⁸⁴ The idea that foreign owners might lead individual firms to adopt more effective diversion constraints is much more plausible, however. So is the idea that the presence of foreign owners can be a diversion constraining force in and of itself.

4.3.1.1 The Extent of Foreign Ownership

It is worth noting at the start that many of the larger corporations from countries not having the most effective constraints on diversions have a considerable portion of their shares held by investors from countries that do. Even more than a decade ago, Anglo-Saxon institutions held an average of 35% of the shares of the largest 40 firms listed on the Paris Bourse and 41% of large Dutch companies.⁸⁵ Foreign investors more generally held over 30% of shares of companies listed on Mexico's stock markets.⁸⁶ However, even where foreign holders have smaller percentages than these, as would be the case with smaller firms in continental Europe and most firms in the developing countries, there are still reasons, as discussed below, why they might have an influence on corporate governance.

4.3.1.2 The Special Role of Foreign Investors

p. 816 Foreign shareholders and domestic non-control shareholders have the same interest in preventing diversions by a firm's control shareholders because, on per share basis, they each lose equally from such diversions. Foreign holders are more likely to act on this interest, however. To start, the foreign holders from strong corporate-governance countries may bring with them a greater familiarity and experience with the kinds of diversion constraints that firms can impose on themselves, and a greater sense that diversions by control shareholders are an improper way of doing business. They and their agents are also less likely than domestic shareholders and their agents to be enmeshed in direct or indirect relationships with a firm's control shareholders that dissuade them from acting to prevent diversions.

The concentration of a country's equity holdings in the hands of institutional investors, characteristic of such wealthy good-governance jurisdictions as the United States and the United Kingdom, also makes holders from these countries more prone to act. This is because larger holders get proportionally greater gains for their efforts, while small holders rationally tend to freeride.

There is evidence that foreign shareholders from strong corporate-governance countries do in fact attempt to cause the adoption of stronger diversion constraints by the foreign firms in which they invest that are from countries with weaker corporate-governance legal regimes and traditions. For example, the California Public Employees Retirement System ("CalPERS") adopted a variety of corporate-governance standards that it urges upon foreign issuers in which it has invested,⁸⁷ and Fidelity has been reported as more aggressive on governance issues in Europe than in the United States.⁸⁸ There is also significant evidence of

4.3.1.3 Methods of Influence

Willingness to act and having influence are two different things. The range of available tools for influence depend on whether the control shareholders have over 50% of the share votes. If they do have more than 50%, it is impossible for foreign shareholders to affect the firm's corporate governance or behavior directly through the way they cast, or threaten to cast, their own votes. They can nevertheless still exercise influence through the threat that if the controlling shareholders fail to heed the foreign shareholders' desires, the foreign shareholders will sell their shares, with a resulting price drop. The reason that the control shareholders may respond to this threat goes back in part to the reasons that the control shareholders wanted the firm to have public shareholders in the first place. All else being equal, they prefer the firm's shares to trade at a higher than a lower price.⁹⁰ The sale of a significant number of shares, even as little as 5–10%, is likely to prompt a lower price, particularly if the market becomes aware that foreign institutional investors, who are likely to be particularly informed about the corporate-governance situation at the firm, have decided to get out. Indeed, because foreign institutional investors are particularly informed, just the public knowledge that control shareholders refused to make changes after one or more such institutions expressed dissatisfaction may result in a share-price drop.

The range of tools of influence expand if the control shareholders have less than 50% of the votes. Then the foreign shareholders have the possibility of providing, at least at the margin, the votes needed to force a change in governance or the elimination of the managers subservient to the control shareholders. Foreign institutional investors, by leading a movement that threatens such a vote, may be able to persuade the controlling shareholders to adopt stronger diversion constraints or simply to divert less without the necessity of a vote actually taking place.

If the control shareholders have less than 50% of the votes, there is also always the possibility of a hostile takeover. Again, the foreign shareholders can be, at the margin, the deciding factor in whether such a takeover occurs. Moreover a foreign institutional investor may be in a better position than any other shareholder credibly to communicate to a potential foreign acquirer the financial gain that could be attained from such a takeover in situations where the network of relationships in the firm's home country makes unlikely a domestic acquirer coming forward. In most situations, the chances are probably relatively small that a foreign institutional investor could help instigate a successful hostile takeover. A domestically instigated takeover attempt that succeeds because of the votes of foreign investors is probably also infrequent. Even so, the stakes for control shareholders in avoiding such a disaster are so high that they may well give some weight to the preferences of the foreign institutions and other foreign investors in order to avoid the risk.

4.3.2 Empirical Evidence

A number of studies provide empirical evidence that greater foreign ownership in fact leads a firm to being subject to more effective diversion constraints. Perhaps the most thorough is the 2011 study by Aggarwal, Erel, Ferreira and Matos ("AEFM").⁹¹ Their starting point is their finding of a strong positive relation between foreign institutional ownership and a measure of a firm's quality of governance.⁹² AEFM conclude that there is in fact a causal pathway leading from greater foreign institutional ownership to improvements in corporate governance.⁹³ They base this conclusion on the use of fixed effects regressions showing a statistically significant positive relationship between a change in foreign ownership and a subsequent change in measures of good corporate governance.⁹⁴ Use of these fixed-effects techniques also rules out the possibility that there is not some other characteristic of the sampled firms—one that correlates with both the extent of foreign ownership and the measure of firm corporate governance—that is the real driver of the observed relation between the two.⁹⁵

AEFM's conclusion that foreign institutional ownership leads to better governance is reinforced by a few of their other findings. To start with, the relationship between foreign institutional ownership and the good governance measure is more intense for firms whose home countries do more poorly on a measure of a good corporate-governance legal regime.⁹⁶ This is exactly what one would expect to see if greater foreign institutional ownership does in fact affect governance: such ownership has more room to make a difference where other constraints on control shareholders are weaker. Two other of their findings relate to

governance outcomes, as opposed to constraints. One is that where foreign ownership is greater, the firm is more likely to replace its CEO if it has recently experienced poor market-adjusted stock returns.⁹⁷ The other is their conclusion that there is a causal pathway leading from greater foreign institutional ownership in a firm to a higher Tobin's Q, i.e., the ratio of a firm's stock market valuation to the book value of its assets.⁹⁸ Tobin's Q is considered a measure of how much management has been able to accomplish for the benefit of portfolio shareholders given the resources that shareholders have provided management to work with. AEFM base this Tobin's Q conclusion on the results of fixed-effects regressions showing a statistically significant positive relationship between a change in foreign ownership and a subsequent change in Tobin's Q.⁹⁹

A number of other studies are, in one way or another, supportive of the idea that greater foreign ownership leads to better governance. Khanna and Palepu, for example, find that in 1994, following India's early-1990s removal of its very substantial barriers to foreign ownership, Tobin's Q had risen more for firms that had achieved higher foreign ownership than it had for firms that had only achieved low foreign ownership.¹⁰⁰ Liang, Lin, and Chin find that in Taiwan, greater foreign ownership is associated with greater voluntary disclosure as measured by frequency of management conference calls.¹⁰¹ They in turn find that these calls contained meaningful information, as measured by the increase in trading activity immediately after.¹⁰² Using an instrumental variable approach, they conclude that the direction of causation is from foreign ownership to more conference calls.¹⁰³ Ferreira, Massa, and Matos find that the greater the percentage of foreign institutional ownership, the more likely it is that the firm will be involved in a cross-border merger and that this effect is stronger when the firm's home country corporate-governance legal regime is weaker.¹⁰⁴ Using an instrumental variable approach, they conclude that the direction of causation runs from foreign institutional ownership to the propensity to be involved in a cross-border merger.¹⁰⁵ Thus, to the extent that the potential of being subject to a cross-border merger has a disciplining effect on the control shareholders (either as an incentive or as a threat), greater foreign ownership will lead to more such discipline by enlarging the likely pool of merger partners.¹⁰⁶ Finally, Iliev et al., in a study of the votes of US institutional investors in non-US firms, find that the larger the percentage of shares held by control shareholders, the more likely these institutions will be to vote against the recommendations of management.¹⁰⁷ Again, this effect is stronger when the firm's home country corporate-governance legal regime is weaker.¹⁰⁸

5 Conclusion

Foreign ownership of publicly traded corporations around the world has increased dramatically in the last few decades. In substantial part, this has been due to the technological and legal changes that have made acquiring and trading shares of issuers from abroad much easier and less expensive. Even more important has been the reduction in the cost of obtaining information about the prospects of issuers abroad. Corporate governance has also been involved in this story with the reduction in impediments acting as a catalyst for both the process by which better corporate governance leads to more foreign ownership and the one by which more foreign ownership leads to better corporate governance.

There is considerable evidence that a firm that displays better corporate governance attracts more foreign investors, whether the better governance is the result of being subject to stronger, more effective corporate and disclosure laws imposed by its home country or the result of the firm's individual actions. This evidence suggests that as the pool of potential foreign investors grows with the reduction in the impediments to global share investing, countries with weak corporate and securities laws will have incentives to strengthen them and make them more effective. It also suggests that many firms whose home countries have weak corporate and securities laws will have incentives to undertake their own individual efforts to improve their own governance and disclosure. Thus the reduction in impediments acts as a catalyst that results in both better corporate governance and more foreign ownership. Countries and individual firms may also improve their corporate governance for reasons independent of the incentives created by the reduction in impediments, but the reduction in impediments still means that these improvements will lead to greater foreign ownership than would have been the case without impediments reduction.

There is also considerable evidence that greater foreign ownership in firms from weak corporate-governance jurisdictions leads to better corporate governance. Here too, the reduction in the impediments to a global market for equities appears to have played a catalytic role. Such a reduction leads to more foreign

investors purchasing shares in issuers from countries with poor corporate governance even if at the time there has been no improvement in the firms' corporate governance. As the foreign investors acquire a larger portion of the outstanding shares of these issuers, they generate new pressure for governance improvement, both through their share votes and through the threat to sell.

An interesting next step in the study of the relationship between foreign ownership and corporate governance would be to consider what developments in the past few decades can tell us about the future. Even if there were no further advances in information technology, there is substantial room for more "learning by doing" in taking advantage of the recent large decline in the cost differences in acquiring information from abroad versus acquiring information domestically. Thus the trends of the past may indeed be prologue.

Notes

- 1 Kenneth R. French & James M. Poterba, "Investor Diversification and International Equity Markets", 81 *Am. Econ. Rev. Papers and Proceedings* 222 (1991).
- 2 These figures were calculated using the same methods and same sources as the 2015 figures in Table 29.2. See note in Table 29.2.
- 3 James L. Cochrane, James E. Shapiro, & Jean E. Tobin, "Foreign Equities and US Investors: Breaking Down the Barriers Separating Supply and Demand", 1 *New York Stock Exchange Working Papers* 95-04 (1995).
- 4 This figure calculated using the same methods and same sources as the 2015 figures in Table 29.2. See note in Table 29.2.
- 5 Total cross-border holding figures come from the US Holdings of Foreign Securities Treasury Report (2015) available at www.treasury.gov/ticdata/Publish/shchistdat.html. From these figures, US investor total worldwide holders in 1994 were calculated as follows (in millions): \$5,067,016 (US Issuer Market Cap) - \$397,703 (Foreign Holdings of US Equity) + \$566,554 (US Holdings of Foreign Equity) = \$5,235,867 (Total Equity Held by US Investors).
- 6 Total cross-border holding figures come from the US Holdings of Foreign Securities Treasury Report (2015) available at <http://ticdata.treasury.gov/Publish/shchistdat.html>. Total market capitalization figures for US issuers and foreign issuers are derived from The World Bank, Market Capitalization of Listed Companies, <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD>.
- 7 The total cross border holdings of both U.S. and foreign investors come from International Monetary Fund, Coordinated Portfolio Investment Survey (2015) Table 11, available at <http://cpis.imf.org>.
- 8 Jung-Koo Kang & Rene M. Stulz, "Why is There Home Bias? An Analysis of Foreign Portfolio Equity Ownership in Japan", 46 *J. Fin. Econ.* 3 (1997).
- 9 See World Bank, Market Capitalization of Listed Companies, available at: <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD>.
- 10 International Monetary Fund, Coordinated Portfolio Investment Survey (2012) Table 11.1, available at: <http://cpis.imf.org>.
- 11 See Table 29.2 and the national ownership figures in the text.
- 12 These figures were calculated using the same methods and same sources as the 2012 figures in Table 29.2. See note in Table 29.2.
- 13 Id.
- 14 Real (as opposed to financial) investment is the use of resources such as skilled labor, machinery, bricks, and mortar to create new capacity in a nation's economy to produce a particular good or service in the future. Financial investment is the acquisition of rights to receive future cash returns: for example, the purchase of a share or bond, the lending of money, or the deposit of money in an interest bearing savings account.
- 15 Theories of individual investment behavior assume that the purpose of saving and investment is to consume the results of the investments at the end of the investment period. Since funds are fungible, whatever the combination of gains and losses on the investments in individual securities that make up the total return, all that counts is the total. Portfolio choice theory tells the investor how to compose a portfolio at the beginning of the investment period that will maximize the expected utility he will derive from the end of period value of this invested wealth (the means of his consumption at that time). If we assume that an investor is a rational maximizer of his expected utility, we can also use the theory to predict his behavior.
- 16 Investors are typically assumed to be "risk averse," i.e., they like expected return and dislike risk. Thus, for any given level of expected return, the lower a portfolio's risk is, the better. The assumption of risk aversion is in turn derived from an assumption that the investor will derive declining marginal utility from consuming his end-of-period wealth, i.e., compared to the utility he gains from any given level of wealth, one dollar more adds less to his total utility than one dollar less subtracts from his total utility. This leads to risk aversion because, compared to the expected utility from a given level of end of period wealth known with certainty, the chance of one dollar over that level does not compensate for an equal chance of one dollar under that level. Thus, in a choice between two portfolios with differing risk, the investor will choose the riskier one only if it has a sufficiently higher expected return to compensate her for the disutility she associates with the greater risk.
- 17 See, William F. Sharpe, "A Simplified Model for Portfolio Analysis", 9 *Mgmt. Sci.* 277 (1963).
- 18 The larger absolute amount of transnational investment by the investors of the nation with relatively greater savings will

be counterbalanced by the smaller absolute amount of such investment by investors in the other nation. If there were a safe asset available and one country's investor were less risk averse than the other, its investors would hold a larger absolute amount of transnational investment relative to if the investors in the two countries were equally risk averse, but again the proportions would be the same.

- 19 See note 8 *supra*.
- 20 John R. Graham, Campbell R. Harvey, & Hai Huang, "Investor Competence, Trading Frequency, and Home Bias", 55 *Mgmt. Sci.*, INFORMS 1094 (2005) (investors tend to shy away from investing in foreign securities if their perceptions are that they lack an understanding in the attendant benefits and risks); French & Poterba, *supra* note 1, at 225 (investors, due to lack of knowledge about foreign markets, institutions, and firms, regard investments in foreign stocks as "unfamiliar gambles" and, even when they assign to a foreign and domestic stock identical probability distributions, impute to the foreign stock a special kind of extra (apparently undiversifiable) "risk," behavior explainable by certain theories of behavioral economics).
- 21 This use of the term "speculator" thus covers both (1) persons who buy or sell for the short run on the basis of information (or evidence of the existence of information) that they believe will soon become more widely known, and (2) investors who purchase for the longer run on the basis of what they believe to be their superior analysis of the "fundamentals."
- 22 This statement may appear inconsistent with the efficient market hypothesis (EMH). The EMH, most broadly stated, is that the market price of a security "fully reflects" all information publicly available at the time in question. See Richard Brealey, Stewart Meyers, & Franklin Allen, *Principles of Corporate Finance* 317–18 (10th ed. 2010) (the prices of established issuers trading in liquid markets reflect all publicly available information). While one of the implications of the EMH is that the ordinary investor is wasting her time trying to pick "winners" on the basis of information she gleans from public sources, a subset of all investors is the persons who initially obtain newly public information and whose trades cause the price to reflect it. Ronald Gilson & Reinier Kraakman, "The Mechanisms of Market Efficiency", 70 *Va. L. Rev.* 549, 569–70 (1984). This subset may be responsible for a substantial percentage of all transactions and would as a result create a home bias in the pattern of holdings. There are sound theoretical reasons for thinking that speculative investors tend to invest in the securities about which they know the most. See, e.g., Robert C. Merton, "A Simple Model of Capital Market Equilibrium", 42 *J. Fin.* 483 (1987) (formal model that shows how segmentation occurs when different groups of investors have different information sets, with each group preferring to trade in the securities about which they have the most information). Geographic proximity to the issuer has been shown empirically to be important even within the US market. Joshua D. Coval & Tobias J. Moskowitz, "Home Bias at Home: Local Equity Preference in Domestic Portfolios", 54 *J. Fin.* 2045 (1999). Prominent financial economists have been suggesting for a long time that this "home country bias" is related at least in part to differences between the information investors possess concerning home country issuers and that concerning foreign issuers. See, e.g., Martin Feldstein & Charles Horioka, "Domestic Savings and International Capital Flows", 90 *Econ. J.* 314, 316 (1980) (finding a high correlation between marginal increases in domestic savings and in domestic investment and attributing these in part to investors' greater uncertainty concerning foreign issuers due to less information); Martin Feldstein, "Domestic Saving and International Capital Movements in the Long Run and the Short Run", 21 *Eur. Econ. Rev.* 129, 130–31 and 148 (1983) (finding substantial imperfections in the international capital market and attributing them in part to investors having a higher subjective variance on foreign returns due to less information); Robert E. Lucas, Jr., "Interest Rates and Currency Prices in a Two-Country World", 10 *J. Monetary Econ.* 335, 357 (1983) (explaining home bias as the result of the local nature of information, but noting the lack of models that even begin to give an understanding of the relationship); Ian Cooper & Evi Kaplanis, "Home Bias in Equity Portfolios, Inflation Hedging, and International Capital Market Equilibrium", 7 *Rev. Fin. Stud.* 45 (1994) (taxes and extra costs of foreign investing cannot fully explain the extent of home bias and attributing a substantial portion of it to investor lack of knowledge concerning foreign issuers); Jung-Koo Kang & Rene M. Stulz, "Why is There a Home Bias? An Analysis of Foreign Portfolio Equity Ownership in Japan", 46 *J. Fin. Econ.* 3 (1997) (similar conclusion based on an examination of the Japanese firms in which foreign investors choose to invest).
- 23 The questions being addressed here apply to the information processing by a whole network of persons—the participants in the "finance process"—whose decisions ultimately determine which real investment projects are implemented. The role played by these different participants—project proponents, firm managers, financial intermediaries, investment advisers and individual investors—and the nature of the rules by which these participants process information is considered in more detail in Merritt B. Fox, *Finance and Industrial Performance in a Dynamic Economy: Theory, Practice and Policy* 92–232 (1987).
- 24 For an example in the legal literature of the use of this kind of "reputation theory," see, e.g., Ronald J. Gilson & Robert H. Mnookin, "Coming of Age in a Corporate Law Firm: The Economics of Associate Career Patterns", 41 *Stan. L. Rev.* 567, 578–79 (1989).
- 25 World Bank, Imports of Goods and Services (% of GDP), available at <http://data.worldbank.org/indicator/NE.IMP.GNFS.ZS>.
✎
- 26 Exchange Act Section 12(a) prohibits any member, broker, or dealer from effecting on a national securities exchange any transaction in "any security" not registered on such an exchange in accordance with the provisions of the Act. Section 13 sets out the registration procedure and provides the statutory basis for the SEC's system of ongoing periodic disclosure by issuers whose securities are registered under the Act.
- 27 Exchange Act Section 15(d). The overall structure of the reach of the US disclosure regime with respect to primary offerings and secondary trading involving the shares of foreign issuers is discussed in detail in Merritt B. Fox, "The Political Economy of Statutory Reach: US Disclosure Rules in a Globalizing Market for Securities", 97 *Mich. L. Rev.* 696, 705–17 (1998).
- 28 *Morrison v. Nat'l Austl. Bank*, 130 S. Ct. 2869, 2828 (2010).

29 Merritt B. Fox, "Securities Class Actions Against Foreign Issuers", 64 Stan. L. Rev. 1173, 1176 (2010).

30 One might think that an easy solution to this problem arises because, with modern technology, it is no more costly in resource use terms for US investor orders to be sent to a foreign exchange than to be sent to a US exchange. US investors can simply purchase their foreign issuer shares in foreign markets. See section 3.2.3 *infra*. The problem is more complicated than this, however. For reasons inherent in the way that even the most advanced exchanges currently work, most traders, whether individual or institutional, must place their orders through a broker-dealer who is a member of the exchange to which the order is sent. Under current US law, foreign broker-dealers, the ones that would be members of the foreign exchanges, face legal difficulties dealing with US investors located in the United States. US broker-dealer rules could be liberalized so that it becomes easier for foreign broker-dealers to deal with US resident investors, but then US investors will not receive the consumer protection that the regulation of US broker-dealers and the regulation of US exchanges provide.

31 Fox, *supra* note 29, at 1205–06, 1254–1255; Fox, *supra* note 27, at 706–08.

32 Fox, *supra* note 29, at 1191–1204; Fox, *supra* note 27, at 730–44.

33 Fox, *supra* note 27, at 706 n.21, 714.

34 Acceptance from Foreign Private Issuers, Securities Act Release No. 8879, Exchange Act Release No. 57,026, 73 FR 986 (Jan. 4, 2008); see especially 17 C.F.R. 230.701(e)(4) and Form 20-F(G)(h)(2) referenced in 17 C.F.R. 249.220f.

35 *Morrison v. Nat'l Austl. Bank*, 130 S. Ct. 2869 (2010).

36 *Id.* at 2888.

37 For a general discussion of fraud-on-the-market suits against foreign issuers and the impact of *Morrison*, see Fox, *supra* note 29, at 1199–1203, 1243–63.

38 The exception would be foreign issuers that in fact find it beneficial to impose on themselves, as a form of bonding, the strict US disclosure regime. See section 4.2.4. The attraction of a US listing to these issuers can be maintained, however, by making being subject to the US disclosure regime optional, rather than a required part of an offering or cross listing.

39 Where the number of shares sold to portfolio shareholders is sufficiently large that, after the sale, the shareholders who had control until then no longer possess enough shares to retain control, these former control shareholders are no longer capable of effecting diversions to themselves. This determinant of the value of the cash flows available to portfolio investors drops out. It is replaced, however, by the agency costs associated with the managers of a dispersed ownership corporation. As discussed in the seminal article by Jensen and Meckling, these agency costs consist of the sum of the costs of management decisions that diverge from what would be in the portfolio investors' best interests and the monitoring and bonding costs incurred to keep these divergences to a minimum. Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 J. Fin. Econ. 305, 308 (1976). Because firms outside of the United States and the United Kingdom predominantly have control shareholders, the discussion that follows in the rest of this chapter assumes, for the convenience of exposition, that the foreign issuers involved each have always had, and will continue to have, controlling shareholders. For firms where at some point this assumption is no longer correct, the focus of corporate-governance shifts from constraining control shareholder diversions to constraining agency costs, but, if the reader makes this substitution, most of the discussion is as applicable to management-controlled firms as ones with controlling shareholders.

40 See George A. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism", 84 Q. J. Econ. 488 (1970). The classic article applying this kind of asymmetric information model to the issuance of securities is Stewart C. Myers & Nicholas S. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have", 13 J. Fin. Econ. 187 (1984).

41 For a more extended discussion of these antidotes, see Merritt B. Fox, "Due Diligence with Residential Mortgage Backed Securities" (hereinafter Due Diligence) available at <http://ssrn.com/abstract=235679>.⁷¹

42 These limitations are discussed in Fox, Due Diligence at note 41 *supra*.

43 The seminal articles in signaling theory are Michael Spence, "Job Market Signaling", 87 Q. J. Econ. 355 (1973); Steven A. Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory, in *Issues in Financial Regulation* (Franklin Edwards ed., 1979).

44 The theory that an intermediating merchant can serve this role can be traced back to Akerlof's seminal article on asymmetric information. See Akerlof, *supra* note 40, at 496. The theory has been applied specifically to the use of the investment bank in the offering of securities. See James R. Booth & Richard L. Smith, II, "Capital Raising, Underwriting and the Certification Hypothesis", 15 J. Fin. Econ. 261 (1986); Ann E. Sherman, "Underwriter Certification and the Effect of Shelf Registration on Due Diligence", 28 Fin. Management J. 5 (1999).

45 See Linda D. DeAngelo, "Auditor Independence, 'Low Balling,' and Disclosure Regulation", 3 J. Acc'ting and Econ. 113 (1981).

46 For a discussion of the superiority of a mandatory disclosure regime over a voluntary choice of a disclosure regime offered by a stock exchange or through a choice of jurisdiction, see Merritt B. Fox, "Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment", 85 Va. L. Rev. 1335 (1999).

47 Easterbrook and Fischel slightly refine this statement of basic norms in corporate law. Unequal divisions of gains from corporate activity will be tolerated, they suggest, provided that the transaction makes no shareholder worse off. Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 143–44 (1991).

48 At least as importantly, disclosure can reveal failures by an issuer to follow the procedures, such as an informed independent director or shareholder vote, for approving transactions in which the controlling shareholders have an interest. These procedures are designed to prevent diversions. For an elaboration of this point, see Merritt B. Fox, "Civil Liability and Mandatory Disclosure", 109 Colum. L. Rev. 237, 258–59 (2009).

49 See, e.g., OECD Principles of Corporate Governance (2004); Mark J. Roe, "Corporate Law's Limits", 31 J. Leg. Stud. 233

- (2002) (corporate law is ineffective without transparency).
- 50 The possibility of an IPO gives venture capitalists an option to exit successful start-ups in a way that allows the founders to retain control. In so doing, this possibility permits a kind of implicit contracting that allows promising innovative projects to move forward that otherwise would not move forward and adds to the incentives for engaging in entrepreneurial activity. See Bernard Black & Ronald Gilson, "Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets", 47 *J. Fin. Econ.* 243 (1999).
- 51 Rafael La Porta, Florencio Lopez-De-Silanes, & Andrei Shleifer, "Corporate Ownership around the World", 54 *J. Fin.* 471 (1999); Stuart L. Gillan & Laura T. Starks, "Corporate Governance, Corporate Ownership and the Role of Institutional Investors: A Global Perspective" (John L. Weinberg Center for Corp. Gov., U. Del., Lerner College of Bus. & Econ., Working Paper No. 2003-01, 2003), at 28.
- 52 A country, of course, is a collection of individuals and may not have collective decision making that maximizes the aggregate wealth of the individuals composing it. Improved corporate governance creates losers as well as winners and the losers may be able to block the change. See Mancur Olsen, *The Logic of Collective Action* (1971). Professors Rajan and Zingales hypothesize that the losers to the strengthening of corporate governance and disclosure have a good chance of succeeding unless an economy is open to both international capital flows and trade. They argue that this hypothesis explains the decline in financial development after World War I and its rise, even after controlling for the level of economic development, in recent decades. It also explains the substantial differences at any given time in the level of financial development across countries with the same level of economic development. Raghuram G. Rajan & Luigi Zingales, "The Great Reversals: The Politics of Financial Development in the Twentieth Century", 69 *J. Fin. Econ.* 5 (2003).
- 53 Professors Hansmann and Kraakman, for example, suggest that there has been an ideological convergence around the world centering on a "shareholder-oriented" model of corporate law based on a belief that it has efficiency benefits that will increase the wealth of each jurisdiction that adopts it. Henry Hansmann & Reinier Kraakman, "The End of History for Corporate Law", 89 *Geo. L.J.* 439, 443–49 (2001). To the extent that this is the case, the growth of this ideology would be an independent driver of stronger corporate governance and mandatory disclosure regimes. It has also been suggested that because of the efficiency benefits of this model, firms that are not subject to it will be disadvantaged in competition with those that are. *Id.* at 449–52, Ronald J. Gilson, "Globalizing Corporate Governance: Convergence of Form or Function", 49 *Am. J. Corp. L.* 329, 336 (2001). The competitive pressures on the nonconforming firms would thus be another driver for such change, which is accentuated by the increase in international trade. Another independent driver is the growing number of portfolio shareholders in each country resulting from increased wealth and privately based pensions. Hansmann & Kraakman at 451–53. A final possible independent factor is the risk that corporate assets will be expropriated by the government. If this risk is high, concentrated ownership may seem a necessity in order to have sufficient political power to fend the government off. When the risk lowers, less concentrated ownership is safer from an expropriation. So there are more situations where greater portfolio ownership would be advantageous to both a firm's control shareholders and portfolio investors if the problem of expected diversions could be solved. See Rene M. Stulz, "The Limits of Financial Globalization", 60 *J. Fin.* 1595 (2005). This in turn could lead to domestic political pressures to improve a country's corporate governance and disclosure laws.
- It should be noted that not everyone agrees that these independent drivers actually have much effect on the quality of corporate governance. Lucian Bebchuk & Mark J. Roe, "A Theory of Path Dependence in Corporate Ownership and Governance", 52 *Stan. L. Rev.* 127 (1999) (path dependence creates sharp resistance to these drivers); Tarun Khanna, Joe Kogan, & Krishna Palepu, "Globalization and Similarities in Corporate Governance: A Cross-Country Analysis", 44 *Eur. Econ. Rev.* 748 (2002) (using de facto measures of corporate governance, no evidence that countries that are more integrated in terms of product trade and labor mobility have more similar corporate governance than ones less integrated in these ways).
- 54 See, e.g., Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer, & Robert W. Vishny, "Legal Determinants of External Finance", 52 *J. Fin.* 1131 (1997).
- 55 See European Corporate Governance Network (ECGN), *The Separation of Ownership and Control: A Survey of 7 European Countries Preliminary Report to the European Commission* (1997); Stijn Claessens, Simeon Djankov, & Larry Lang, "Expropriation of Minority Shareholders in East Asia", 57 *J. Fin.* 81 (2001); Charles P. Himmelberg, R. Glenn Hubbard, & Inessa Love, "Investor Protection, Ownership and Investment" (2000), available at <http://www.nber.org/china/ghubbard.pdf>.
- 56 Reena Aggarwal, Leora Klapper, & Peter D. Wysocki, "Portfolio Preferences of Foreign Institutional Investors", 29 *J. Banking & Fin.* 2919 (2005) (finding that US mutual funds tend to invest more in countries with stronger shareholder rights and legal frameworks, even after controlling for the country's economic development). Khanna, Palepu, & Srinivasan find a positive relationship between a non-US firm's transparency measure and the equity owned by US investors in the firm's home country firms as a percentage of their total capitalization. While this result could be explained by US investors preferring investments in firms from countries with laws imposing more effective diversion constraints on its issuers, consistent with Aggarwal, Klapper, & Wysocki, it also could be explained by a higher percentage of firms willing to individually impose on themselves effective diversion constraints in some countries than others. Tarun Khanna, Krishna Palepu, & Suraj Srinivasan, "Disclosure Practices of Foreign Companies Interacting with US Markets", 42 *J. Acct. Research* 475, 499–500 (2004).
- 57 It is true that the governments of some of the wealthiest countries, in particular the United States, advocate good governance, both directly and through their roles in the international financial institutions, and that wealthy countries are the source of most foreign investors in the firms of the countries of the rest of the world. The motivation for this kind of advocacy, however, appears to be to promote economic development in poorer countries and perhaps to expand a financial system in which some of the wealthy country's citizens earn rents. It is unlikely that the intensity of this advocacy

applied by any one wealthy country is strongly positively correlated with the percentage of shares already held by the wealthy country's investors in the firms of the particular country being lobbied. Such a strong positive correlation would be needed for advocacy by wealthy countries to drive a causal link running from greater foreign ownership to stronger, more effective governance laws.

58 See section 4.1.3.

59 Aggarwal, Klapper, & Waddock, *supra* note 56 (positive correlation between firms that score well on good governance measures with extent of foreign ownership); Reena Aggarwal, Isil Erel, Miguel Ferreira, & Pedro Matos, "Does Governance Travel Around the World? Evidence from Institutional Investors", 100 *J. Fin. Econ.* 154, 161–164, 171–72 (2011) (same); Magnus Dahlquist & Goran Robertson, "Direct Foreign Ownership, Institutional Investors, and Firm Characteristics", 59 *J. Fin. Econ.* 413 (2001) (correlation between foreign ownership and low concentration of ownership); Christian Leuz, Karl Lins, & Francis Warnock, "Do Foreigners Invest Less in Poorly Governed Firms", 22 *Rev. Fin. Stud.* 3245 (2009) (US investors hold substantially smaller equity positions in non-US firms with poor scores on a transparency measure); Vicentiu M. Covrig, Mark L. Defond, & Mingyi Hung, "Home Bias, Foreign Mutual Fund Holdings, and the Voluntary Adoption of International Accounting Standards", 45 *J. Acct. Research* 41 (2007) (correlation between firms that voluntarily adopt international accounting standards and foreign ownership); Jia-Weng Liang, Mei-Feng Lin, & Chen-Lung Chin, "Does Foreign Institutional Ownership Motivate Firms in an Emerging Market to Increase Voluntary Disclosure", 39 *Rev. Quant. Fin. Acct.* 55 (2012) (positive relationship between percentage of foreign ownership of Taiwanese firms and voluntary disclosure as measured by conference calls, which are shown to be informative by the fact that they are followed by greater institutional ownership turnover); Miguel A. Ferreira & Pedro Matos, "The Color of Investors' Money: The Role of Institutional Investors around the World", 88 *J. Fin. Econ.* 499 (2008) (for non-US firms, correlation between the extent of US institutional ownership and higher market to book value (Tobin's Q), which arguably is an indicator of better governance); Kimberly A. Webb, Steven F. Cahan, & Jerry Sun, "The Effect of Globalization and Legal Environment on Voluntary Disclosure", 43 *Int'l. J. Accounting* 219 (2008) (correlation between a measure of a firm's voluntary disclosure and a measure of its country's integration into the global economy including global capital markets, with the effect being stronger for firms from countries with weaker legal environments).

60 See section 4.3.1.

61 See section 4.1; Hansmann & Kraakman, *supra* note 53, at 451 (participants in international equity markets "understandably prefer shareholder-oriented governance"). As discussed further in section 4.3.1, Aggarwal et al. using fixed effects regressions, find a statistically significant positive relationship between a change in foreign ownership and a subsequent change in measures of good corporate governance, which suggests that foreign ownership leads to better corporate governance. In contrast, interestingly, they find no statistically significant relationship between a change in measures of good corporate governance and a later change in foreign ownership. Aggarwal, Erel, Ferreira, & Matos, *supra* note 59, at 167–70. This latter result, of course, is not an affirmative finding that good governance does not lead to more foreign ownership. The test may simply have not been powerful enough to pick up evidence of such a causal relationship. One possibility is that such a causal relationship does exist, but that the lag structure between a governance change and any changes in foreign ownership may be more complicated than the lag structure going the other way and that this makes the relationship harder to test for.

62 Covrig, Defond, & Hung, *supra* note 59.

63 Tarun Khanna & Krishna Palepu, "Emerging Market Business Groups, Foreign Investors, and Corporate Governance" (Nat'l Bureau of Econ. Research, Working Paper No 6955, 1999).

64 *Id.*

65 See, e.g., John C. Coffee, Jr., "Racing Towards the Top? The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance", 102 *Colum. L. Rev.* 1757 (2002); Rene Stulz, "Globalization, Corporate Finance, and the Cost of Capital", 26 *J. Appl. Corp. Fin.* 3 (1999).

66 Section 3.2.3.

67 See, e.g., Jordan Siegel, "Can Foreign Firms Bond Themselves Effectively by Submitting to US Law", 75 *J. Fin. Econ.* 319 (2005); Mark Lang, Jana Smith Ready, & Wendy Wilson, "Earnings Management and Cross Listing: Are Reconciled Earnings Comparable to US Earnings", 42 *J. Acc'ting and Econ.* 285 (2006).

68 Traditionally, foreign issuers were required to disclose just as much as US issuers making a public offering, Harold Bloomenthal, 1980 *Securities Handbook*, 354–57 (1980), but in 1982, the SEC adopted registration forms exclusively for foreign issuers. Securities Act Release 6437 (Nov. 19, 1982).

69 SEC Release No. 34-55540 (2007) available at <http://www.sec.gov/rules/final/2007/34-55540.pdf>.

70 *Morrison v. Nat'l Austl. Bank*, 130 S. Ct. 2869 (2010).

71 *Id.* at 2888.

72 Section 3.2.3.

73 For a general discussion of fraud-on-the-market suits against foreign issuers and the impact of *Morrison*, see Merritt B. Fox, "Securities Class Actions Against Foreign Issuers", 64 *Stan. L. Rev.* 1173, 1176, 1199–1203, 1243–63 (2012).

74 S. Foerster & G.A. Karolyi, "The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the US", 54 *J. Fin.* 981 (1999); Darius Miller, "The Market Reaction to International Cross-Listings: Evidence from Depositary Receipts", 51 *J. Fin. Econ.* 103 (1999); Craig Doidge, "US Cross-Listings and Private Benefits of Control", 72 *J. Fin. Econ.* 592 (2004); Craig Doidge, G.A. Karolyi, & Rene Stulz, "Why Are Foreign Firms Listed in the US Worth More?", 71 *J. Fin. Econ.* 205 (2004) (hereinafter *Worth More*); Craig Doidge, G.A. Karolyi, & Rene Stulz, "Has New York Become Less Competitive Than London in Global Markets? Evaluating Foreign Listing Choices Over Time", 91 *J. Fin. Econ.* 253 (2009).

See, e.g., Luzi Hail & Christian Leuz, "Cost of Capital and Cash Flow Effect of US Cross Listings", 93 *J. Fin. Econ.* 428 (2009).

75 Doidge, Karolyi, & Stulz, Worth More, *supra* note 74.

76 William A. Reese Jr. & Michael S. Weisbach, “Protection of Minority Shareholder Interests, Cross-Listing in the United States, and Subsequent Equity Offerings”, 66 J. Fin. Econ. 65 (2002).

77 Hail & Leuz, *supra* note 74.

78 Doidge, *supra* note 74.

79 Arturo Bris, Salvatore Cantale, & George P. Nishiotis, 13 Eur. Fin. Mgmt. 498 (2007).

80 *Id.*; Doidge, *supra* note 74.

81 *Id.*; Bris, Cantale & Nishiotis, *supra* note 79.

82 Urgur Lel & Darius P. Miller, “International Cross-Listing, Firm Performance, and Top Management Turnover: A Test of the Bonding Hypothesis”, 63 J. Fin. 1897 (2008).

83 *Id.*

84 Section 4.2.2.

85 Gilson, *supra* note 53, at 346.

86 Stuart L. Gillan & Laura T. Starks, “Corporate Governance, Corporate Ownership and the Role of Institutional Investors: A Global Perspective”, John L. Weinberg Center for Corp. Gov., U. Del., Lerner College of Bus. & Econ., Working Paper No. 2003-01, 2003, at 29.

87 Gilson, *supra* note 53, at 346–47.

88 Aggarwal et al., *supra* note 59, at 155.

89 Marco Becht, Julian Franks, & Jeremy Grant, “Hedge Fund Activism in Europe”, ECGI Working Paper 283/2010 (2010) (study of 305 activist interventions in UK and continental European corporations, more than half of which involved a US or UK firm intervening in the governance of a continental European corporation).

90 Reasons why a majority control shareholder would care about the firm’s share price may include its ability to sell some of its own shares at a higher price, the ability of domestic individuals and institutions that hold firm shares and with which the control shareholder has relationships to sell their shares at a higher price, a desire for these domestic persons or institutions to use whatever political influence they have in support of government policies favoring the firm, the ability of the firm itself to obtain new equity financing at favorable terms, and the simple prestige and social benefits arising from being the control shareholder of a firm with higher priced shares. See, generally, Sang Yop Kang, “Re-Envisioning the Controlling Shareholder Regime: Why Controlling and Minority Shareholders Often Embrace”, 16 U. Pa. J. Bus. L. 843 (2014).

91 Aggarwal et al., *supra* note 59.

92 *Id.* at 161.

93 *Id.* at 167–70.

94 *Id.*

95 This conclusion is subject to the caveat that these fixed-effect results would not rule out the existence of an alternative driver of the observed relationship if the alternative driver itself tended to change from one period to the next.

96 *Id.* at 164–167.

97 *Id.* at 172 (table 9) (showing a statistically significant mean interaction effect between foreign institutional ownership and the previous period’s market-adjusted return).

98 *Id.* at 173.

99 *Id.* A caveat is necessary with respect to these two governance-outcome-related reinforcing findings. AEFM have similar findings with respect to the effect of domestic institutional holdings on the sensitivity of CEO turnover to poor stock returns and the effect of changes in domestic institutional holdings on subsequent periods’ Tobin’s Q. Thus, to the extent that foreign and domestic institutional ownership, or changes in each, is correlated, it may not be the foreignness of the holdings that matters, but their institutional nature. This concern is significantly alleviated, however, by a study by Ferreira and Matos (“FM”). FM find a strong statistically significant positive relation between foreign institutional ownership and non-US firms’ Tobin’s Qs, and between “independent” institutional ownership (mutual funds, both foreign and domestic) and non-US firms’ Tobin’s Qs, but not between “grey” institutions (bank trusts and insurance companies) and non-US firms’ Tobin’s Qs, nor between domestic institutional ownership and non-US firms’ Tobin’s Qs. Miguel A. Ferreira & Pedro Matos, “The Color of Investors’ Money: The role of Institutional Investors Around the World”, 88 J. Fin. Econ. 499, 500–01, 517 (2008) Using an instrumental variable technique, they find the direction of causation is from the ownership factor to Tobin’s Q, not the other way around. *Id.* at 517.

100 Tarun Khanna & Krishna Palepu, “Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups”, 55 J. Fin. 867 (2000) at Table 3.

101 Liang, Lin & Chin, *supra* note 59, at 66.

102 *Id.* at 70–71.

103 *Id.* at 72–73.

104 Miguel A. Ferreira, Massimo Massa, & Pedro Matos, “Shareholders at the Gate? Institutional Investors and Cross-Border Mergers and Acquisitions”, 23 Rev. Fin. Stud. 601, 617 (2010).

105 *Id.* at 622–25.

106 In addition, if the dominant party in the takeover is the foreign firm and it is from a country with better governance, the assets of the acquired company will become utilized in an enterprise with better governance.

107 Peter Iliev, Karl Lins, Darius Miller, & Lukas Roth, “Shareholder Voting and Corporate Governance Around the World”, 28 Rev. Fin. Studies 8 (2015).

108 *Id.*