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How Investors Respond When Foreign Firms on U.S. Exchanges are Sued for Financial Fraud

By Lei Chen

Financial fraud is extremely expensive for investors. But not enough attention is paid to financial fraud committed by foreign firms cross-listed on a U.S. exchange. Recognizing the importance of this topic to the global investing community, I have investigated how corporate governance influences the incidences of financial fraud committed by cross-listed firms and the market reactions to it. Accordingly, I have considered two corporate governance mechanisms and their ability to impact this issue: legal and political institutions on the country level, and independent auditor quality on the firm level.

Listing on a U.S. stock exchange is appealing to corporations based outside the U.S. for many reasons. Academic research indicates that listing on a U.S. stock exchange provides companies with increased visibility, exposure, and prestige, and also decreases capital costs by improving

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Although it is generally believed that listing on a U.S. exchange affords better investor protection than most regulatory frameworks outside the U.S., it is still not entirely clear whether a U.S. listing is enough to fully compensate for corporate governance differences across the globe. Indeed, foreign firms listed on U.S. exchanges frequently commit alleged fraud with significant economic fallout, including sizeable shareholder losses.

liquidity, facilitating risk-sharing, and overcoming market segmentation. More importantly, it is believed that listing on a U.S. exchange strengthens corporate governance practices and reduces investors' risks and costs. In fact, a detailed look at recent trends in securities fraud and related litigation show that both a company's country of incorporation and choice of exchange clearly impact how it is viewed by the global investing community.

The so-called "bonding theory" may partially explain this phenomenon. The bonding theory provides that when a company that is incorporated outside the U.S. lists stock on a major U.S. exchange (like the New York Stock Exchange or NASDAQ), such a listing helps constrain corporate insiders from abusing their executive positions and enriching themselves at the expense of public investors. The bonding theory further emphasizes the benefit of reducing investor risks and costs. The reasoning behind the bonding theory is that a corporation based outside the U.S. becomes subject to more stringent investor protections by virtue of their U.S. exchange listing. Such protections include the federal securities laws and the regulatory oversight and enforcement provided by the U.S. Securities and Exchange Commission (the "SEC"), among other designated regulators. Such protections also include more rigorous monitoring from American-based gatekeepers, like financial analysts and institutional and activist investors. The bonding theory also provides that the benefits of listing on a major U.S. exchange are particularly great for companies that are incorporated in countries without exacting regulatory frameworks and with less accountable political institutions and judicial systems.

Although it is generally believed that listing on a U.S. exchange affords better investor protections than most regulatory frameworks outside the U.S., it is still not entirely clear whether a U.S. listing is enough to fully compensate for corporate governance differences across the globe. Indeed, foreign firms listed on U.S. exchanges frequently commit alleged fraud with significant economic fallout, including sizable shareholder losses. Several infamous cases in point involved Royal Ahold Corp., based in the Netherlands; Nortel Networks Corp., based in Canada; and Lernout & Hauspie Speech Products, N.V., based in Belgium. Further, according to the Class Action Filings-Foreign Index constructed by Cornerstone Research, alleged fraud committed by foreign issuers as a percentage of all alleged fraud in securities class actions has generally increased since 1996 — peaking in 2007 at 16.4 percent. And despite moderate declines in 2008 and 2009, lawsuits alleging fraud by foreign issuers rebounded considerably in 2010 and 2011, mostly due to fraud charges against Chinese companies for improper financial accounting, which caused investor trading losses when disclosed to the public.

By examining securities class action lawsuits filed between January 1996 and October 2011 — which can serve as a proxy for financial fraud — I identified 272 cases of financial fraud committed by 242 foreign firms listed on U.S. exchanges. The three countries with the highest ratio of fraud cases were Germany (3.7 percent), China (3.5 percent), and Switzerland (3.2 percent). By comparison, the United Kingdom and Israel had much lower ratios (1.9 percent and 1.3 percent, respectively), and Canada had the lowest ratio (0.6 percent). Overall, the data indicated that there were significant trading losses and hits to shareholder value when fraudulent scandals were revealed to the investing public.

Furthermore, firms based in countries with weaker corporate governance — generally, civil law countries, not common law countries — were more susceptible to shareholder suits alleging securities fraud. For example, after controlling for other factors, the probability of a corporation in a common law country being sued for fraud was 0.76 percent, far lower than the 1.08 percent probability of a fraud suit against a company incorporated in a civil law country.

In addition to U.S. exchange listings and the political establishments in place in countries around the world, the inverse relationship between local corporate governance regimes and fraud incidents may also be attributable to the retention of a "Big 4" auditor — Pricewaterhouse-Coopers, Deloitte, Ernst & Young, or KPMG. Indeed, the Big 4 auditors can have a moderating effect in countries with weak corporate governance, which corroborates the conjecture that reputable auditors have a corporate governance role in emerging markets. In other words, when Big 4 auditors are hired to independently verify companies' financial statements, companies from countries with weak investor-protection regimes are less likely to engage in financial misconduct than companies with less reputable auditors.

Moreover, since not all financial fraud is exposed and thus not all companies that commit fraud are sued by shareholders, my research also examined whether U.S. investors factored undiscovered fraud into their stock valuations. For instance, if a Chinese-based company listed in the U.S. is sued for securities fraud, what happens to other Chinese-based companies that are also listed on that U.S. exchange? In other words, does the shareholder lawsuit have negative spillover effects on the other Chinese-based companies? Economically, the data underlying my "spillover analysis" suggests that, on average, the answer is yes. Non-sued firms that are based in the same home country as a sued firm lost substantial amounts of their equity value under such circumstances. Taken together, my findings suggest that the market is wary of undiscovered financial fraud, which can lead to reputational fallout for all firms — sued and not sued — that are incorporated in the same country and listed on the same U.S. exchange. Significantly, however, the "good" firms seemed able to (at least partially) separate themselves from the "bad" firms by hiring Big 4 auditors, especially when they are based in countries with weak corporate governance, and therefore suffered less negative spillover effects.

While additional research may identify other corporate governance mechanisms that might be used to substitute poor shareholder protections on the country level, executive officers and directors in boardrooms across the world who seek to improve corporate governance structures should consider retaining a Big 4 independent auditor and make careful decisions about exchange listings, including whether to tap into the U.S. capital markets in an effort to engender investor confidence. ✦

About the Author

Dr. Lei Chen is a Post-doctoral Fellow in the Department of Accounting at the London School of Economics and Political Science. His research interests include corporate governance, financial fraud, disclosure quality, and shareholder rights.

Dr. Chen's working papers include "How do national and global business elites connect? The case of the People's Republic of China" (2011, co-authored with Kees van Veen); "The market for independent directors" (2012, co-authored with Frank Moers, received The Credit Mutuel Nord Europe — La Francaise AM Best Ph.D. Paper Prize from ECCCS Ph.D Symposium and Workshop); and "Does country of origin matter — an investigation of financial fraud by cross-listed firms in the U.S. market" (2012, received "Highly Commended" paper award from the 10th International Conference on Corporate Governance, Center for Corporate Governance Research, University of Birmingham). Dr. Chen's current projects include "The networks of top managers in the U.S." (with Kees van Veen and Roger Leenders); "Short sellers' role in producing and disseminating information for the financial market, and discovering potential financial fraud;" and "Shareholder activism and information quality" (with Frank Moers and Michael Viehs).

Dr. Chen is a frequent presenter and lecturer on accounting, finance and corporate governance at conferences across the globe. A recipient of numerous academic scholarships, Dr. Chen received his Ph.D. in Finance from Maastricht University in the Netherlands, his M.Sc. in International Business and Management from the University of Groningen in the Netherlands, and his B.Sc. in Management Science from Sichuan University in China.

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