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Voluntary disclosure, transparency, and market quality: Evidence from emerging market ADRs

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Abstract

Extant research has also documented the relatively inferior legal and political environment for governance that obtains in several emerging market countries. When firms from emerging markets cross-list their equity in major international markets they have to mandatorily improve their disclosure levels in accordance with the stringent requirements of regulators and stock exchanges. The work of Bacidore and Sofianos [Bacidore, J.M., Sofianos, G., 2002. Liquidity provision and specialist trading in NYSE-listed non-US stocks. Journal of Financial Economics 63 (1), 133–58] provides evidence that companies from emerging markets face much higher adverse selection costs when they trade their ADRs in the U.S. Using the recently available disclosure scores developed by Credit Lyonnais Securities Asia (CLSA), we find that companies from emerging markets that issue ADRs have significant cross-sectional differences. This finding suggests that firms have incentives to increase the level of voluntary disclosures. One such incentive could be their improved liquidity when they trade in markets, such as New York stock exchange and Nasdaq. Using a market microstructure framework, this paper examines empirically whether there exist cross-sectional differences in effective spread, depth and adverse selection component of spread that are related to disclosure quality. Our empirical evidence indicates that firms with higher disclosure scores have significantly lower adverse selection component of spread ceteris paribus. There appears to be an information premium for firms with lower

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disclosure quality. Voluntary disclosures by managers seem to have a beneficial impact on the firm's liquidity.
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1. Introduction

"*Foreign companies are getting at our capital without having to conform to our higher disclosure standards*" laments Fredric E. Russell who heads an investment management firm in Tulsa, OK.[1] Although all foreign firms that wish to list securities on an U.S. exchange or Nasdaq must register them under the Securities Exchange Act of 1934, the financial reporting requirements are less stringent as compared to U.S. companies. For instance, foreign companies may report semiannually rather than quarterly. Moreover, they do not have to report segment data, and also do not have to prepare a full set of financial statements in accordance with U.S. GAAP. Instead, foreign issuers are required to provide annually, on Form 20-F, a quantitative reconciliation of non-U.S. GAAP net income and shareholders' equity to U.S. GAAP amounts.

A possible outcome of the less stringent disclosure regime of foreign securities listed and traded on U.S. exchanges is that investors and market makers are faced with increased information asymmetry. If indeed information asymmetry is worse for foreign issues, then insiders and other traders with better access to information have incentives to exploit their advantage to the detriment of outsiders. However, Chowdhry and Nanda (1991) develop a model which shows that the principal features of U.S. security markets, such as rapid public dissemination of price information and better monitoring of insider trading deter informed trading. Bhattacharya and Daouk (2002) in a comprehensive study on insider trading in the major markets of the world conclude that although over 80% of the emerging markets and all the developed markets have laws against insider trading, persecutions are much less common. Only 25% of the emerging markets have had persecutions based on insider trading laws. Thus, informed traders who wish to exploit their informational edge have incentives to concentrate their trades in the home countries of cross-listing stocks. Previous studies on international cross-listings by Forster and George (1994) and Barclay et al. (1990) indicate that most informed trading in foreign companies' shares occur in the home markets of these firms.

Although prior research indicates that information asymmetry is higher in the case of ADRs as compared to domestic firms, the regulatory environment in the U.S. is not conducive for elevated levels of insider trading. It appears that insiders with substantial informational advantage have incentives to concentrate their trades in the home countries of firms issuing the ADRs.

Empirical evidence on information asymmetry of ADRs as compared to U.S. stocks is mixed. The work of Bacidore and Sofianos (2002) indicates that non-U.S. stocks have

[1] See Elizabeth MacDonald "Cherchez la footnote", Forbes.com, 01.07.2002.

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