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Insider trading law enforcement and gross spreads of ADR IPOs

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ABSTRACT

Using American Depositary Receipt (ADR) IPOs from 34 countries during 1980–2004, we find that, on average, the enforcement of insider trading laws reduces the underwriter gross spread by 49–61 basis points, which is about 10–12% of the average gross spread for ADR IPOs. This relation is present regardless of whether issuers have a prior listing or whether issuers are from developed or emerging markets. The association becomes stronger for ADRs underwritten by less prestigious underwriters and for issuers that are involved in privatization. The political institutions in the issuers' home markets also affect gross spreads.

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1. Introduction

We examine the association between a country's insider trading law enforcement and the gross spreads charged by underwriters for American Depositary Receipt (ADR) initial public offerings (IPOs). Our prediction is that stricter insider trading regulation in the issuer's home market reduces investment banks' costs of underwriting ADR IPOs and their costs of making a market in the IPO stocks, therefore reducing the fees underwriters charge for bringing the foreign firm public in the United States. Our study builds on the argument that lax oversight of insider trading will create adverse selection and discourage investment, thus depressing stock market participation and liquidity (Ausubel, 1990; Leland, 1992).

The underwriters of ADR IPOs bear costs arising from the lack of insider trading regulation in the issuers' home markets. First, when issuers are from markets without insider trading regulation, underwriters take more risk in damaging their reputation capital. Reputation capital is vital to the investment banking business (Beatty and Ritter, 1986; Nanda and Yun, 1997), and reputational bonding is valuable for foreign firms listed in the United States. Doidge et al. (2004) find that foreign firms listed in the United States are worth more, suggesting that a US listing reduces the extent to which insiders can engage in expropriation. However, Siegel (2005) argues that American governance of US-listed foreign firms is much stricter in writing than in actual practice, so it is the reputational bonding rather than legal bonding that creates value for foreign firms listed in the United States. Underwriters, as the major financial intermediaries for ADR IPOs and as repeated players in capital markets, put their reputation capital at stake to help foreign issuers with reputational bonding; thus strict insider trading regulation in the issuer's home market reduces the risk that underwriters face.

Second, it is more costly for underwriters to conduct due diligence for issuers from markets without insider trading regulation. Insider trading can crowd out information collection by outside investors by limiting their gains (Fishman and Hagerty, 1992). Outside investors spend fewer resources in collecting information if the probability of trading with insiders is high. Stricter insider trading regulation improves the general information environment (Bushman et al., 2004; Lagoarde-Segot, 2009), and thus makes underwriters more capable of detecting potential problems.

Moreover, IPO underwriters are often the market makers of the IPO stocks (Ellis et al., 2000). As the market maker, underwriters will bear additional liquidity risk and adverse selection risk when the issuer is from a market without insider trading regulation. Bacidore and Sofianos (2002) compare NYSE-listed non-US stocks with US stocks. They find that all else being equal, non-US stocks have wider bid-ask spreads than US stocks, mainly because non-US stocks have higher information asymmetry and greater

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adverse selection risk. Because insider trading increases information asymmetry and gives rise to additional adverse selection problems, insider trading regulation can mitigate these problems. Overall, to compensate for the risks that we discuss above, underwriters of ADR IPOs tend to charge higher gross spreads if the issuers are from markets without strict insider trading regulation.

Our sample includes Level III ADR IPOs from 34 countries during 1980–2004. Our sample period spans rich variation in insider trading regulations as well as legal and political institutions. For instance, until 1989, when the European Union implemented mandatory compliance with the European Community Insider Trading Directive (89/592/EEC of November 13, 1989), insider trading was not illegal in most European countries. In our sample, 23 out of 34 countries experienced their first enforcement of insider trading laws during our sample period. This provides a well-balanced sample and an excellent setting to test for the effect of insider trading law enforcement on the gross spreads of ADR IPOs.

We find that, on average, enforcement of insider trading laws reduces the gross spread of ADR IPOs by 49–61 basis points, which is about 10–12% of the average gross spread for ADR IPOs. This relation is present regardless of whether the issuer has a prior exchange listing and whether the issuer is from a developed or emerging market. The effect of the enforcement of insider trading laws on gross spreads is stronger for ADR IPOs underwritten by less prestigious underwriters and for issuers that are involved in a privatization.

Our findings are robust to controlling for political and legal institutions. Importantly, we find that political institutions also affect the gross spread of ADR IPOs. Depending on whether legal origins are controlled for, a one standard deviation increase in political rights is associated with a 22–36 basis points decline in gross spreads, which is about 4–7% of the average gross spread for ADR IPOs.

Our study makes several contributions. First, it increases our understanding of how the legal and political systems in the issuer's home country affect the issue costs of ADR IPOs. As the financial market becomes increasingly globalized, it is important to understand the determinants of the cost of raising capital, particularly the country-level variables. Our findings suggest that enforcing insider trading law in the home country reduces the cost of raising equity capital in the United States. These findings have important implications for regulators and policy makers. Furthermore, we provide evidence on how financial intermediaries incorporate insider trading regulations, political rights, and legal systems into the pricing of underwriting services. Our empirical results have implications for the Global Depository Receipt (GDR) markets and the financial intermediaries that underwrite GDR offers around the world.

Second, our work complements the studies on insider trading laws and political rights by demonstrating that stricter insider trading regulations and stronger political rights can reduce the cost of raising equity capital beyond the home market. Our study is closely related to Bhattacharya and Daouk (2002), Qi et al. (2010) and Boubakri and Ghouma (2010). Bhattacharya and Daouk (2002) find that the cost of equity in a country decreases after the first enforcement of insider trading laws. Using a sample of corporate bonds issued in the Eurobond market, Qi et al. (2010) find that country-level political rights have a strong impact on the cost of debt. Using a sample of debt issuing firms from developed and developing countries, Boubakri and Ghouma (2010) find that a better protection of debt holders' rights reduces the cost of debt financing. Our study extends the literature by showing that both insider trading law enforcement and political rights affect the cost of raising equity capital in the international market.

The remainder of the paper is organized as follows. In Section 2, we review the related literature. In Section 3, we discuss our data and sample. In Section 4, we present our empirical results. Section 5 concludes this study.

2. Related literature

Given that a large number of international firms have made their first equity offerings in the United States over the past decades, it is important to understand how US investment bankers set gross spreads of ADR offers. To the best of our knowledge, Chen et al. (2009) present the only study that attempts to address this question. Although they show that ADR IPO gross spreads can be explained by various firm and offer characteristics, we know little about whether the political and legal systems in the home country also affect the gross spreads of ADR IPOs. Although political and legal systems in a country have long been recognized as having an important effect on financial and economic development, the literature mainly focuses on the effects *within* a country. Our purpose is to extend the literature by considering how the political and legal institutions of a country determine a firm's cost of raising equity capital in international markets. In particular, we focus on the impact of insider trading regulations on the gross spreads of ADR IPOs.

2.1. Insider trading regulations

Insider trading regulations have been shown to affect the cost of equity. Specifically, Bhattacharya and Daouk (2002) show that the cost of equity in a country is reduced significantly following the enforcement of insider trading laws. Bushman et al. (2005) and Fernandes and Ferreira (2009) provide further evidence on the mechanism through which the enforcement of insider trading laws contributes to a reduction in the cost of capital. However, these studies examine the relation between insider trading regulations and the cost of equity only within individual countries. In this study, we focus on the relation between insider trading regulations in the home country and the cost of raising equity outside the home country. In particular, we examine whether the gross spreads of ADR IPOs can be reduced by insider trading law enforcement in the home country.

Considerable disagreement exists on whether cross-listing in US exchanges can effectively deter insider trading among foreign issuers, especially before 2005. For example, Coffee (2002) argues that American laws covering US-listed foreign firms can potentially deter insider trading. However, using a sample of Mexican firms between 1995 and 2002, Siegel (2005) reports that the Securities Exchange Commission (SEC) rarely prosecutes transgressions of US-listed foreign firms. The evidence indicates that the SEC may not be an effective enforcer.[1] In addition, Siegel also presents evidence that the dollar amount of settlements in private lawsuits is relatively small, suggesting that private lawsuits may not have the desired deterrence effect either. As Siegel (2005) concludes, "American governance rules affecting US-listed foreign firms are much stricter in writing than in practice," and "ADRs are far from a perfect substitute for strong foreign law enforcement in preventing fraud, theft, embezzlement, and legal asset taking."

This would lead us to believe that, for ADRs, if US insider trading regulations cannot completely substitute for the lack of insider trading regulations in the foreign issuer's home country, we can expect to find that stricter insider trading regulations in the issuer's home country reduce the issue costs of ADR IPOs.

[1] In January 2005, the US SEC accused the CEO of TV Azteca, a Mexican firm, of insider trading. Bryant-Rubio (2005) has more details. Note that this case occurred after the end of our sample period.

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