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ADR characteristics and corporate governance in the Greater China region

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Abstract

We examine the relationship between firm valuation and governance mechanisms, firm characteristics, and institutional factors of the American Depository Receipts (ADRs) domiciled in the Greater China region. We find that China ADRs have the highest market-to-book value ratio followed by Hong Kong and Taiwan ADRs. It appears that Chinese firms with the poorest external governance environment stand to benefit the most from cross listing under the ADR programs. Listing in the U.S. that requires more stringent regulations and disclosure rules may strengthen the firms' governance practices and thereby enhance their firm value. Among the internal governance mechanisms, institutional ownership and insider ownership are important for firm value.
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1. Introduction

Good corporate governance mechanisms are value enhancing, and their importance on firm value has long been established since the pioneering work of Jensen and Meckling (1976) in a nexus of contracts among various stakeholders. Under the rubrics of principal–agent conflicts, Shleifer and Vishny (1997) emphasize that investor protection is crucial. La Porta et al. (1998, 2000, 2002), who examine the importance of external governance around the world, show that common-law countries provide better shareholder protection than civil-law countries, and better shareholder protection is associated with higher valuation of corporate assets, and poor shareholder protection is penalized with lower valuations.

Recent research has focused on the combined determinants of corporate governance on firm performance. In particular, board structure (Yermack, 1996; Boone et al., 2007; Linck et al., 2008), CEO characteristics (Hermalin and Weisbach, 1998; Basu et al., 2007; Brookman and Thistle, 2009), and ownership structure (Lemmon and Lins, 2003; Ali et al., 2007) have been identified as key determinants of a firm's governance practices. Firms with more independent directors and higher managerial ownership are linked to stronger governance and better firm performance. Against the backdrops of these findings, Gillan (2006) provides a comprehensive review of internal and external governance systems, and their interactions.

In this study, we contribute to the literature as we examine firm performance across various external governance regimes under the American Depository Receipts (ADRs) programs. In particular, we examine firm performance from the Greater China region, namely China, Hong Kong, and Taiwan, cross-listed in the U.S. with stronger law enforcement and investor protection (see La Porta et al., 1998). This is the case for both Level II and Level III ADRs that are required to follow the same stringent requirements on governance, disclosure requirements, and accounting standards as those of the U.S. firms, especially after the Sarbane-Oxley Act in 2002 (see Durnev and Kim, 2005; Doidge et al., 2003).[1] It could be argued that the ADRs from

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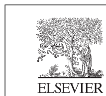

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[1] ADRs under Level I and 144A rules are not listed on a stock exchange and do not need to comply with the same U.S. requirements. Level II ADRs use existing shares to satisfy investor demand and liquidity, and Level III ADRs are a public offering of new shares into the U.S. markets. Both Level II and Level III

the Greater China region should benefit higher market valuation from cross-listing in the U.S.

Part of our interest in examining the impact of ADRs from the Greater China region in relation to corporate governance on firm value is motivated by the contrasting external legal environment and the internal governance mechanisms (or the lack of them) among these markets. Although China's regulatory framework has evolved rapidly, its external and internal governance mechanisms remain the weakest in comparison to those of Hong Kong and Taiwan (see, e.g., Sun and Tong, 2003; Wei, 2007; Tian and Estrin, 2008).[2] According to La Porta et al. (1998), Taiwan that follows the civil-law regime coupled with weaker investor protection is exposed to a poorer governance environment, whereas Hong Kong with its legal origin from the common-law regime tends to enjoy stronger legal enforcement.

It follows that while firms based in the Greater China region enjoy close business ties and trades, their exposure to various governance environments should provide a fertile ground to examine the differential impact of the ADR listings on firm value. Therefore, it is hypothesized that on average, China ADRs with the weakest governance mechanisms may benefit the most in the form of higher firm valuation, followed by Taiwan and Hong Kong ADRs, respectively.

Our results confirm that China ADRs enjoy on average the highest market-to-book value ratio after controlling for governance measures and firm characteristics. It suggests that Chinese firms, moving from the poorest external governance regime to the U.S., tend to benefit the most via the ADRs experience.

However, Hong Kong ADRs, embedded with stronger governance at home, have the next highest market-to-book ratio after listing in the U.S. and Taiwan ADRs that come from a weaker governance regime, on the other hand, appear to gain the least in terms of market valuation. In our view, these results may be driven by distinct firm effects that exist among the three markets. More specifically, Hong Kong ADRs include both Hong Kong-based private-sector firms and China-based state-owned enterprises listed in Hong Kong, while Taiwan ADRs consist of firms exclusively in high-tech industries. This contrast in firm type implies that Taiwan ADRs are likely to operate in more competitive industries than their Hong Kong counterparts. As Giroud and Mueller (2011) argue that product market competition may act as a substitute for corporate governance as competitive pressure imposes discipline on managers to maximize firm value, Taiwan ADRs should, therefore, experience stronger governance. It follows that Hong Kong ADRs, which tend to be in less competitive industries based on Giroud and Mueller's proposition and thus weaker governance, should benefit more than Taiwan ADRs from the ADR listings.

Among governance measures, both institutional ownership and insider ownership are important for firm value. These results are consistent with prior studies (e.g., McConnell and Servaes, 1990; Hartzell and Starks, 2003; Cornett et al., 2007) that higher insider ownership reduces potential agency conflicts between insiders and minority shareholders, and institutional ownership seems to play an effective monitoring role for the ADR firms. Our results complement Sun and Tong (2003) who document that share issue privatization in China is positively related to firm performance but state ownership is negatively related to firm performance.

The remainder of the paper is organized as follows. Section 2 provides an overview of the corporate governance environment in the Greater China region. Section 3 discusses sample and methodology. Empirical results are reported in Section 4 and Section 5 concludes the paper.

2. Corporate governance in the Greater China region

2.1. China

China's legal regime can be traced to German civil law, which is on average weaker than English common law in terms of investor protection (La Porta et al., 1998). Coupled with high proportions of state ownership and control for publicly listed firms, the corporate governance environment in China is arguably the weakest among the three markets in the region (see Sun and Tong, 2003; Wei, 2007; Tian and Estrin, 2008).[3]

Since 1990s, China has adopted a two-tier board structure that comprises the board of directors and the supervisory board to improve governance. The aim is to impose a two-layer oversight on the duty and performance of the senior management. That is, the board of directors monitors senior managers, and the supervisory board monitors and evaluates the performance of both senior managers and the board of directors. The governance of the board structure has further been strengthened after *the Code of Corporate Governance for Listed Companies in China* was introduced in 2002 that requires some degree of board independence, and qualifications and knowledge of supervisory board members.

However, Wei (2007) contends that although these governance measures were already put in place, most corporate boards are still characterized by insider control and weak independence. Tam (2002), Lin (2004), and Wang (2007) also find that supervisory boards are ineffective in playing their roles of overseeing the performance of directors and managers.

The lack of independence of directors and supervisory members is perhaps not surprising as the predecessors of Chinese listed firms are mostly state-owned enterprises (SOEs), whose managers are often appointed as directors of the newly privatized firms. The consequence is that directors are rarely independent and managers tend to dominate the governance of the board. Similarly, most supervisory members are considered insiders because they tend to come from political offices, labor unions, close friends, and allies of the senior management (Dahya et al.,

ADRs are traded on one of the three major U.S. exchanges, i.e., NYSE, AMAX, or NASDAQ.

[2] The core regulatory framework consists of *The Company Law* since 1993, *the Securities Law* since 1998, and *the Code of Corporate Governance for Listed Companies in China* since 2002.

[3] The majority of shares outstanding in Chinese firms are non-tradable shares owned by state/local governments or their affiliated entities.

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