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Incorporating Field Data into Archival Research

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Abstract:

I explore the use of field data in conjunction with archival evidence by examining Iliev, Miller, and Roth's [2014] analysis of an amendment to the Securities Exchange Act of 1934. This regulatory amendment allowed depositary banks to cross-list firms without the cooperation of foreign issuers. Iliev, Miller, and Roth [2014] argue that the regulation failed to fulfill its intended purpose and imposed significant costs on foreign firms for the benefit of depositary banks. Drawing on evidence from lawyers, issuers, depositary banks, and regulators involved in the design and implementation of the amendment, I describe a more optimistic assessment of the amendment and its effects on capital markets. I conclude by discussing opportunities for field data in financial reporting and disclosure research.

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1. *Assessing the Objectives and Effects of Regulatory Change*

There are questions fundamental to the design and implementation of any legislation. Did the regulatory change satisfy its objectives? Who were the parties that stood to gain and lose from its implementation? Did the change create any unforeseen consequences?

The answers to these questions often depend on what information one chooses to analyze. Consider, for example, criticism that arose after the passage of the Affordable Care Act in the United States. During public speeches, President Obama and Congressional leaders often mentioned that Americans would be able to keep their current insurance plans, if desired, under the new act.¹ However, in late 2013 when the new healthcare legislation went into effect, millions of Americans began to receive cancellation notices. Immediately, criticism mounted that consumers had been duped and those with preexisting coverage were being unexpectedly harmed by the law. To an archival researcher relying on the public statements of President Obama, these cancellations would almost certainly appear as an unexpected and undesirable surprise.

Yet, there is considerable evidence that many individuals- regulators, lobbyists, insurance executives, hospital administrators- knew that some insurance plans would be cancelled once the new regulation went into effect.² The *Federal Register* even detailed the expected disruptions to the private insurance market.³ Thus, the cancellation of policies is only surprising if one relied exclusively on the public statements made by President Obama.

While this example is quite simple, it illustrates the different interpretations that can arise depending on what data one examines. To evaluate whether the cancellations

¹ As an example, President Obama said “no matter what you’ve heard, if you like your doctor or health care plan, you can keep it” during his weekly address on August 15, 2009.

² Several fact checking organizations described, during the passage of the legislation, evidence that some individuals would not be able to keep their insurance. For example, see <http://www.factcheck.org/2009/08/keep-your-insurance-not-everyone/>.

³ Interim Final Rules for Group Health Plans and Health Insurance Coverage Relating to Status as a Grandfathered Health Plan Under the Patient Protection and Affordable Care Act (*Federal Register*, Volume 75, No. 116).

should be described as an *unforeseen* consequence of the Act's passage requires analyzing the totality of information available at the time. This includes not only the public statements of President Obama, but also field commentary and memorandum from other individuals and constituencies involved in the design and passage of the Act. These latter sources provide "field data," evidence that is often only accessed by speaking with the actual practitioners involved in the design of legislation.

Field data are an important supplement to archival evidence. Yet, financial reporting and disclosure researchers often restrict themselves largely to analyzing archival data that are publicly accessible. In this example, that is analogous to relying on the public statements of President Obama to evaluate whether the cancellations ought to have been expected.⁴ Given the tendency for politicization and over-simplification in public discourse, field data are especially useful when evaluating the expectations and objectives of regulatory changes.

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In this article, I seek to illustrate the opportunities offered by employing field evidence in conjunction with archival research. I examine an amendment to the Securities Exchange Act of 1934 that had significant transnational consequences and was the subject of an analysis by Iliev, Miller and Roth [2014] (henceforth, IMR). I draw extensively from field evidence including interviews with those involved with the design and implementation of the amendment, as well as with those impacted by its passage (i.e. lawyers, issuers, depository banks, investors, auditors, and regulators). I also include evidence from other relevant sources including the Federal Register and comment letters sent to the SEC.⁵ I utilize this information and related empirical data provided by these groups to evaluate the inferences offered by IMR. At times this field

⁴ Securities regulations often entail considerable more complexity and uncertainty in interpretation than this simplified example.

⁵ Beginning in August 2004, the SEC began publicly releasing comment letters. Prior to this, comment letters were only accessible via the Freedom of Information Act. For more background about the decision to release these documents publicly, see "Deafened by the S.E.C.'s Silence, He Sued" *New York Times*, May 28, 2006.

evidence supports IMR's findings. In other instances, this evidence suggests an alternative narrative.

The amendment under consideration in IMR automatically exempted a foreign issuer from registering with the Securities and Exchange Commission (SEC) if its equity securities traded on an international exchange and the firm published periodic financial documents online and in English.⁶ By automatically exempting foreign issuers from the registration requirements of the Securities Act, regulators created the opportunity for depositary banks to cross-list such foreign issuers in the United States without the involvement of the foreign issuers themselves. These cross-listings, created without the cooperation of management, became known as "unsponsored" depositary receipts.

While the amendment passed with little fanfare in 2008, it soon had a significant effect on securities markets in the United States. Within three months, nearly 700 new unsponsored depositary receipt programs were created. In some cases, multiple depositary banks created competing depositary receipts for the same underlying foreign issuer. These depositary receipts could have different rights and rates of return depending on the conditions of the supervising depositary bank.

IMR argue that the creation of unsponsored American Depositary Receipts (ADR's) imposed significant costs on foreign issuers. IMR document a reduction, on average, of between 4.1% and 6.4% in firm value of companies that were involuntarily cross-listed by depositary banks. They argue that this reduction in value arises, in large part, from the increased litigation risk found in the United States. IMR substantiate this litigation cost argument by examining the audit fees of unsponsored programs, which they find increase when an unsponsored ADR program is created by a depositary bank.

While IMR find that the amended Securities Act had negative ramifications for foreign issuers, they also provide evidence that the creation of unsponsored ADRs led to significant revenue opportunities for banks. IMR argue that these revenue opportunities led to the explosive growth in the unsponsored ADR market. IMR characterize the

⁶ See "Exemption From Registration Under Section 12(G) of the Securities Exchange Act of 1934 for Foreign Private Issuers", RIN 3235-AK04, for a complete description of the requirements.

actions of depository banks as evidence that securities regulation can be “exploited for private gain” and create “costly unintended consequences.” In the end, IMR present a dispiriting assessment of an American regulatory action that benefited financial intermediaries at the expense of foreign issuers. They conclude that the amendment to the Securities Act ultimately failed to fulfill its stated objective of “increasing voluntary OTC cross-listings through a reduction in compliance costs.”

I focus on bringing field evidence to bear on two central questions raised in IMR’s analysis. First, what was the objective of this regulatory change and did it fulfill this objective? Second, did the amendment unexpectedly expose foreign issuers to “costly unintended consequences” in the form of additional litigation risk?

In contrast to the conclusions of IMR, I suggest that the amendment succeeded in fulfilling its main policy objective of making foreign securities more accessible to domestic investors. I also provide evidence that suggests that IMR’s analysis potentially overestimates the litigation risk faced by unsponsored listing.⁷

The objective for this article is two-fold. First, I seek to illustrate the potential opportunities offered by employing additional field evidence in IMR’s analysis of two key issues. Sections 2 and 3 of this paper discuss the objective of the amendment and its impact on litigation risk. Although I reexamine a number of issues in IMR through a field-based perspective, it should be noted that this article is not a complete re-analysis of their paper or the amendment itself. Rather, it is a discussion of the strengths and weaknesses of their analysis and the ways field evidence could enhance the inquiry.

My second objective is to describe the value of utilizing field evidence to build hypotheses and validate inferences in financial accounting research more generally. In Section 4, I describe the merit of this approach by discussing a related set of studies that have become popularly known in the management literature as the “Honda Effect.” I explain how using more detailed field evidence could enhance the narrative offered by IMR as well as financial reporting and disclosure research more broadly.

⁷ This paper utilizes “listing” in reference to OTC traded equities, as is common in the academic literature. However, a quotation based market, rather than “listing” which connotes comparisons to the NYSE, AMEX, or NASDAQ process, would more aptly describe the OTC securities market.

2. Objective of Amending Section 12(g) of the Securities Act of 1934

On February 13, 2008, nearly seven months before the passage of the amended Securities Act, Elliot Staffin, Special Counsel at the SEC, gave a speech describing the proposed amendment. During his speech, Staffin noted that under the proposed amendment, foreign issuers would no longer need to file paper copies of their disclosure documents with the SEC to receive an exemption from the registration requirements of the Exchange Act. By simply posting English language copies of filings on their websites, foreign issuers could automatically satisfy the disclosure requirement needed to claim an exemption. After describing several additional proposed conditions foreign issuers would need to satisfy in order to be exempt, Staffin concluded his speech by saying that the SEC believed, “the proposed rule amendments will benefit investors by increasing their access to a foreign private issuer’s non-U.S. disclosure documents while at the same time reducing that issuer’s costs of compliance.”⁸

Citing Staffin’s speech, IMR infer that reducing compliance costs for foreign issuers was one the primary objectives of the amendment.⁹ By reducing filing costs, the amendment would remove one of the impediments faced by foreign issuers who sought to cross-list into the United States. Following this, IMR reason that the “new rule intends to reduce compliance costs and thus increase the number of voluntary (sponsored) OTC cross-listings.”

In their analysis, IMR do not explicitly describe the specific compliance costs that are reduced by the amendment. However, in the final promulgation of the amendment

⁸ This point was described further in the final rule in the Federal Register. Specifically, “the adopted amendments should make it easier for U.S. investors to gain access to a foreign private issuer’s material non-United States disclosure documents and thereby to make better informed decisions regarding whether to invest in that issuer’s equity securities through the over-the-counter market in the United States or otherwise” (Federal Register, Vol. 71, No. 176, RIN 3235-AK04.)

⁹ Staffin’s speech did not specifically say that a reduction in compliance cost was an explicit purpose of seeking passage of the amendment. Instead, a reduction in compliance costs was simply one of the benefits associated with the passage of the amendment. Staffin’s complete remark that motivated IMR’s interpretation was: “we believe the proposed rule amendments will benefit investors by increasing their access to a foreign private issuer’s non-U.S. disclosure documents while at the same time reducing that issuer’s costs of compliance under Rule 12g3-2(b).”

in the Federal Register, the filing costs eliminated by the amendment are described in detail. According to the estimates offered by the commission, foreign issuers filed twelve submissions, on average, each year to maintain their exception status. Each of these submissions required four hours of preparation time with the assistance of external lawyers, accountants, and translators. The commission estimated that legal and accounting expertise cost \$400/hour and English translation services cost \$125/hour. Based on these numbers, the commission estimated that the amendment reduced compliance costs by \$7,390, on average, for each foreign issuer.¹⁰

Even if the SEC's estimate of the compliance costs are too conservative (e.g. preparation time averages more than four hours, legal fees tend to be higher than \$400/hour, etc.), the reduction in filings costs is modest. However, according to IMR's interpretation, regulators implicitly believed that this limited reduction in filing costs would substantially shift foreign firms' willingness to cross-list into the United States. Specifically, IMR conclude that the amendment was unsuccessful because it "did not achieve its intended purpose of increasing voluntary OTC cross-listings through a reduction in compliance costs" (35). If correct, it would imply that regulators incorrectly conjectured that a \$7,390 reduction in filing costs would spur a significant change in cross-listing behavior. This interpretation not only suggests that the amendment failed to achieve its objective, but it also suggests that regulators poorly understood the cost-benefit calculation underlying a foreign issuer's decision to cross-list.

This criticism is prefaced on the belief that regulators actually believed that growing voluntary (i.e. sponsored) OTC cross-listings was the intent of the regulation.¹¹ Is there some alternative objective of the legislation that is simply not being as explicitly promoted by the SEC?

¹⁰ The burden and filing costs associated with filing a Form F-6 filing would not be eliminated under the amendment because in the case of an unsponsored listing it would change from the foreign issuer to the depositary bank.

¹¹ Beyond Staffin's remarks, some additional evidence in both the proposed and final rule to suggest that the purpose of the legislation, as least as officially stated, was to increase more voluntary listings. Specifically, in the final rule, it stated that the "adopted rules amendments are designed to encourage more foreign companies" to claim the regulatory exemption that would facilitate listing in the United States.

The comment letters sent to the SEC prior to the passage of the amendment show how market participants viewed the intended purpose of the amendment.¹² These comment letters suggest that the purpose of the legislation was somewhat different than that being outwardly described by the SEC. In particular, while all seemed to agree that the ultimate goal was increasing the availability of foreign securities for investors in the United States, *how* this would be achieved (via voluntary or involuntary listing) differs.

IMR suggest that the amendment sought to create sponsored listings and the creation of unsponsored cross-listings was an unanticipated and even undesired consequence. However, many comment letters focus on the expectation that more unsponsored ADRs would be created. Comment letters include discussions of the merits of unsponsored ADRs, the limitations associated with sponsored ADRs, and the process by which depositary banks would create unsponsored listings. This differs notably from the “official” stated purpose emphasized in the proposed and final ruling on which IMR focus their evaluation around.

One letter from BNY Mellon is representative. On the first page of its letter, BNY Mellon explicitly noted its desire to grow the unsponsored ADR market.

“We believe that under the Proposal, many additional foreign issuers would qualify for exemption under the Rule by virtue of their existing practices...Depositary banks would then be able to register unsponsored ADR programs for those foreign issuers immediately, without the involvement of those foreign issuers.”

Other comment letters even describe the need to expand the unsponsored ADR market because the sponsored market is too small. For example, The Bank of New York described the need to expand the unsponsored market, because the supply of sponsored listing was insufficient for the demands of American investors.

¹² The SEC received 40 comment letters from a variety of institutions including law firms, depositary banks, and trade associations. These comment letters were received by the Commission between February and August 2008 with the majority of the letters sent at least five months before the final passage of the amendment.

“...non-U.S. issuers have become reluctant, if not unwilling, to subject themselves to any level of U.S. securities regulation, including taking action to obtain an exemption pursuant to Rule 12g3-2(b) or signing a registration statement on Form F-6. As a result, the number of sponsored American Depositary Receipt (“ADR”) programs is declining... The inadequate supply of sponsored ADR programs does not serve the objective of investor protection, since sponsored ADR programs allow investors to more fully participate in the benefits of owning equity securities of non- issuers while affording them numerous protections.”

Evidence in the final rule indicates that regulators were keenly aware of the potential growth in the unsponsored ADR market prior to the passage of the amendment.¹³ Notably, regulators could have limited the growth of unsponsored ADR’s simply by requiring an agent of the foreign issuer sign the Form F-6 filed by the depositary bank.¹⁴ Such a requirement would have had no effect on the reduction in compliance costs, but would have eliminated the depositary banks’ ability to create unsponsored listings without the cooperation of foreign issuers. The commission knowingly decided to avoid such a requirement, thereby facilitating the growth of unsponsored cross-listings.

The deliberate choice by the SEC to facilitate the creation of unsponsored ADR’s speaks to the intended beneficiaries and purpose of the amendment. IMR frame the success or failure of the legislation around how firms would cross-list (i.e. voluntarily or involuntarily) and the consequences of its passage on foreign issuers. However, the final legislation was implicitly framed around the benefits for American investors and seems ambivalent about how this would actually be achieved.

The SEC was aware of the constraints faced by many institutional and individual investors wishing to invest in foreign equities. Given the diversification benefits associated with such investments, the amendment sought to increase American

¹³ Specifically, in the final rule, the SEC stated that “we concur with those commenters who stated that imposing additional conditions could run counter to the goal of streamlining the Rule 12g3-2(b) regime for the benefit of investors and issuers, we are not adopting at this time any additional conditions regarding the formation of unsponsored ADR facilities”(45).

¹⁴ Several comment letters supported the idea of allowing foreign issuers to “opt-in”. See the comments letters by The International Bar Association (April 25, 2008) and Deutsche Bank (April 21, 2008). The SEC rejected this approach in the final rule and agreed with those comment letters that did not impose an “opt-in” condition (see prior footnote).

investors' access to foreign securities by increasing the supply of cross-listed securities. This growth in the ADR market could occur through the growth of sponsored or unsponsored cross-listings. The comment letters, along with the final text of the amendment, seem to express little concern about how this growth is achieved (i.e. sponsored or unsponsored).

While the number of new sponsored listings after the passage of the amendment was not large, the number of new unsponsored listings was significant. Figure 1 shows the number of unsponsored programs created. From the passage of the amendment to the end of the second quarter of 2013, nearly 1,500 new foreign issuers were cross-listed in the United States. Even several years after the passage of the amendment, new unsponsored programs were being created. For example, in 2012, over 200 new unsponsored ADR's were created. Such growth is consistent with the desired objective of increasing the availability and accessibility of foreign issuers cross-listed in the United States.

IMR characterize depositary banks as "exploiting the regulation for their private gain" (6). However, the incentives of banks and investors are aligned. Depositary banks are only rewarded with fees when depositary receipts (i.e. shares) of cross-listed firms are created or canceled.¹⁵ Thus, depositary banks that create unsponsored listings for which there is no investor demand will not receive any fee-based income. Depositary banks only generate income when they satisfy investors' desire for cross-listed securities.

Two sets of figures can help further assess the demand for unsponsored ADRs. First, Figure 2 provides descriptive statistics on the level of trading of unsponsored ADRs. Panel A shows that the average trading volume for an unsponsored depositary receipt is over 280,000 shares per month.¹⁶ The aggregate dollar volume of all

¹⁵ For example, BNY Mellon receives \$.25 (or less) per depositary share for issuing or cancelling a share. The bank also generates income in its depositary receipt business for cash distributions (\$.05 or less per share), depositary service fees (\$.05 or less per share on an annual basis), and cable charges (\$17.50 or less per transaction).

¹⁶ The sponsored ADR market is considerably more liquid. During this period, the average sponsored ADR traded 11.4 million depositary shares per month.

unsponsored transactions averaged over \$1.8 billion a month from July 2012 to July 2013. Panel B provides the average monthly trading volume for the ten most actively traded unsponsored programs. These include Li & Fung, the global distributor, and Nintendo, the video game manufacturer. All ten of these firms have unsponsored programs that trade in excess of 2.5 million depositary receipts per month. Overall, these descriptive statistics suggest that the unsponsored ADR market is a significant and active market.

To further understand the demand for unsponsored ADRs, Figure 3 shows the aggregate dollar holdings of unsponsored ADRs for the top ten institutional holders. The purchase of ADRs facilitates international diversification within these institutions' portfolios that might otherwise be constrained. Together, these ten institutions hold over \$16 billion in unsponsored ADRs. The size of these institutional investments shows that the unsponsored ADR market is not a small or fringe market. Rather, the market is supported by large institutional investors.

In summary, the amendment facilitated the creation of unsponsored ADRs. Had there been little demand for depositary receipts, depositary banks would have reaped little profit. However, substantial trading and investment in unsponsored ADRs by institutional investors suggests that there was considerable investor demand which depositary banks sought to satisfy. To the extent that regulators sought to facilitate additional international investment opportunities for domestic investors, the evidence presented here suggests that the amendment was far more successful in achieving its intended objective than depicted by IMR.

These differing views of the amendment's success largely rest on how one interprets the purpose of the legislation. IMR's assessment accurately conveys that the SEC was far more explicit discussing sponsored listings in its public proclamations. These "official statements" do not necessarily represent the complete intentions of those designing the regulation. By examining additional field evidence, I believe the cross-listing effects created by the amendment were both expected and a desired objectives of the regulation.

The nature of political dialogue is that the true intent of regulators is often obscured behind the veil of rhetoric. In the case of President Obama's comments that Americans could keep their insurance under the Affordable Care Act, several staffers defended the President's statements as accurate explaining that during political discourse "simplification and ease of explanation were a premium" and "you inevitably lose some accuracy when you do that."¹⁷ Piercing the shroud of political dialogue to ascertain underlying objectives requires viewing all available information, both publicly accessible archival and field evidence.¹⁸ In this way, academic financial accounting researchers ought to operate like investigative journalists who begin with the public comments (i.e. the "archival" data), but then probe for additional information behind the story (i.e. the "field" data).

3. Litigation Risk

One of the contributions of IMR's investigation is a better understanding of the litigation risk faced by foreign issuers who cross-list into the United States. The litigation risk described by IMR arises when foreign issuers become subject to the more litigious regulatory environment in the United States when they either voluntarily or involuntarily cross-list in the United States. IMR's analysis primarily focuses on the litigation risk faced by unsponsored ADRs, which they argue face substantial litigation risk after being involuntarily cross-listed.

IMR initially appeal to several legal cases to offer support for their argument. The first case IMR describe is that of a firm named Vestas Wind Systems, which JP Morgan cross-listed in July 2008. In March 2011, Vestas was the subject of a class action lawsuit for allegedly making false and misleading statements in regards to its earnings and financial guidance. However, the suit was voluntarily dismissed by the Plaintiff

¹⁷ "Aides Debated Obama Health-Care Coverage Promise" (*Wall Street Journal*, November 2, 2013).

¹⁸ While the analysis is primarily archival, IMR reference several comment letters, which describe the motivations of several market participants, in a note in their Appendix.

within three months of it being filed. Thus, this case does not seem to provide compelling evidence that unsponsored foreign issuers face significant litigation risk.

IMR also describe a suit against Roche Holdings. At the time of the suit, Roche Holdings had established a sponsored ADR program and in May 2002 Roche settled the case for over \$6 million. However, sponsored ADRs are exposed to different litigation risks than unsponsored ADRs. Executives of a foreign issuer who establish a sponsored listing actively seek to engage with American markets. In doing so, executives of sponsored cross-listings expose themselves and their firms to increased litigation by becoming unambiguously subject to personal jurisdiction in American courts.¹⁹ Firms with unsponsored cross-listings, however, would not be subject to the same jurisdictional considerations in American courts since they are not proactively engaging with the U.S capital markets. Consequently, the litigation risk faced by a sponsored ADR listing is not similar to the litigation risk faced by an unsponsored ADR listing. Other examples offered in the paper (e.g. Nortel Networks, Royal Ahold NV, Vivendi Universal S.A) not directly comparable for the same reason.

Although IMR offer these examples to motivate the ex-ante litigation risk faced by unsponsored ADRs, none of these examples specifically describes this risk. Instead, these examples only suggest that the *ex-post* litigation risk faced by unsponsored listing is limited. As *ex-post* evidence, they offer limited insight into the perceived litigation risk facing unsponsored cross-listings.

To better understand the ex-ante litigation risk, I examined memos written by several prominent law firms prior to the passage of the amendment in 2008. These memos heavily focused on the litigation faced by foreign issuers involuntarily cross-listed by depositary banks.²⁰ The memos described the specific laws that involuntarily cross-listed firms could be subject to and the circumstances in which they could reasonably expect to face litigation. Broadly, these memos characterize involuntary

¹⁹ In particular, the establishment of a sponsored ADR program creates specific personal jurisdiction. There is also the potential to create general personal jurisdiction, however most legal scholars seem to agree that the establishment of a sponsored ADR program alone is unlikely to create this form of personal jurisdiction.

²⁰ These legal memos were created for their clients and therefore considered confidential.

cross-listed firms as facing some litigation risk, but conclude that the circumstances in which litigation could be brought against involuntarily cross-listed firms were quite limited. In particular, although managers of involuntarily cross-listed firms did not explicitly choose to cross-list into the United States, American courts could interpret their compliance with the English language disclosure requirements as an indirect effort to establish an ADR program. In doing so, executives at the foreign issuer could avail themselves to Rule 10b-5 violations since it could be anticipated that investors in the United States would rely on these public disclosures even if the disclosures were not created for them.

While it was reasonable to expect that involuntarily cross-listed firms could face some increase in litigation risk, it is difficult to assess the perceived magnitude of this risk due to its conjectural nature. *Ex post*, several pieces of evidence suggest that the litigation risk faced by unsponsored cross-listed firms is low. Broadly, this is supported by the lack of litigation against unsponsored ADRs in the years since the passage of the amended Securities Act. The perceived exposure of foreign issuers to U.S. securities laws also declined with the resolution of the *Morrison v. National Australia Bank* case in June 2010, which held that American securities law does not apply to foreign investors seeking claims outside the United States. The United States Court of Appeals also ruled in August 2013 that Rule 10b-5 violations do not apply to extraterritorial conduct.²¹ As one public Sullivan & Cromwell memo summarizing the litigation risk faced by cross-listed firms noted, “non-U.S. issuers should take some comfort that they will not expose themselves to “worldwide” securities class actions simply by participating in U.S. capital markets.”²²

With this context in mind, one can more readily assess IMR’s empirical analysis around the litigation risk faced by involuntary cross-listed firms. IMR estimate that the

²¹ In the *United States v. Vilar, et al.*, the United States Court of Appeal for the Second Circuit noted that, “a defendant may be convicted of securities fraud under Section 10(b) and Rule 10b-5 only if he has engaged in fraud in connection with (1) a security listed on a U.S. Exchange, or (2) a security purchased or sold in the United States” (Docket Nos. 10-521-cr(L), 10-580-cr(CON), 10-4639-cr(CON).)

²² “The Territorial Reach of U.S. Securities Laws After *Morrison v. National Australia Bank*” September 29, 2011. Sullivan and Cromwell LLP.

average decline in firm value is between 4.1% and 6.4% for foreign issuers that are involuntarily cross-listed by depository banks. This value destruction, according to IMR, arises largely from the increased litigation exposure in the U.S securities market. However, the magnitude of this value appears implausibly large.²³ To see this perspective, Tobin's q is defined as:

$$\frac{\text{Total Assets} - \text{Book Value of Equity} + \text{Market Value of Equity}}{\text{Total Assets}}$$

I assume that the amendment only affected a firm's q value via the change in the market value of equity since it is not obvious why either total assets or the book value of equity would be directly affected by the amendment. The total market capitalization data of unsponsored ADR firms with data available on Bloomberg as of November 2010 (date in Figure 1 of IMR) was nearly \$4.5 trillion dollars. Thus, according to IMR's estimate, the amendment destroyed in excess of \$150 billion, but perhaps as much as \$300 billion, in market capitalization.²⁴

To put the size of this estimate in perspective, Gande and Miller (2012) find that the aggregate loss arising from all class actions suits against foreign firms, most of which are cross-listed in the U.S., from 1996-2008 was \$73 billion.²⁵ Since the sponsored ADR firms in the Gande and Miller sample face an even higher *ex-ante* litigation risk than IMR's sample of unsponsored ADRs, it is unclear why the market would discount the

²³ IMR offer a "back of the envelope" calculation to support that their estimate is reasonable. However, this estimate is not comparable for two reasons. First, this sample is based on an ex-post sample of firms that faced a higher ex-ante litigation risk, specifically sponsored ADR's and foreign-based firms traded in the U.S (e.g. Tyco). Second, the associated valuation loss of 15.7% that IMR cite arises from using a [-10,+1] event window and includes not only litigation costs, but also losses associated with the event that gave rise to the litigation (e.g. earnings restatement, regulatory investigation, etc.).

²⁴ Bloomberg only contains market capitalization data for 346 unsponsored ADR firms as of November 30, 2010. Consequently, the \$150-300 billion estimate actually understates how much market capitalization is estimated to have been destroyed by the passage of the amendment. In particular, the market capitalization of two-thirds of the unsponsored ADRs are not included in this calculation. Their inclusion would only further increase its magnitude.

²⁵ IMR's estimate of the amount of value destroyed by the amendment could include other non-litigation costs. Such factors, if significant, could help account for the magnitude of IMR's estimate. However, litigation risk alone, based on the arguments here, cannot explain the entire value loss estimated in IMR.

unsponsored ADR sample several orders of magnitude higher.²⁶ Moreover, had executives at some of these involuntarily cross-listed firms believed that this amendment destroyed this much firm value, it is surprising that none led a lobbying effort seeking its repeal. For many of the largest and most sophisticated unsponsored ADR's like LVMH, Li & Fung, and BMW, the cost of such lobbying would seem relatively insignificant compared to the amount of value IMR estimate was destroyed at each firm.

Given the magnitude of the value destruction suggested by IMR's analysis, it would be reassuring if they used the known *ex-post* decline in perceived litigation risk as a means of verifying their estimates and identification strategy. Specifically, if IMR's model is correctly specified and litigation risk is accurately priced by the market, the reduction in firm value that arises from perceived litigation risk should diminish over time. Unsponsored listings should not exhibit such a significant discount in value once the uncertainty around the litigation risk faced by foreign issuers was clarified in the years following the passage of the amendment. To facilitate matching, IMR could rely on involuntary cross-listings that depository banks created later (e.g. after 2011) when the perceived litigation risk arising from being involuntarily cross-listed was lower. If correct, replicating their analysis during this later time frame should yield lower reductions in firm value.

Given the methodological challenges of using changes in firm value as a means to identify litigation risk, IMR also examine changes in audit fees around the passage of the amendment. IMR hypothesize that audit firms will raise their fees on involuntarily cross-listed firms because of increased exposure to litigation risk. IMR provide evidence suggesting that audit fees increased by 6.6% once a foreign issuer was involuntarily cross-listed.

²⁶ As an additional point of comparison to IMR's estimate, Cheng, Srinivasan, and Yu (2012) found that aggregate cost to settle every class action lawsuit filed against a foreign cross-listed firm in the 15 year period from 1996-2010 was only \$5.9 billion. These suits are again against sponsored ADRs which face a higher *ex-ante* litigation risk than the sample of unsponsored firms in IMR.

A decision to raise per-unit audit fees on a client is an explicit decision involving the engagement partner of the auditing firm. Auditors should be readily aware of these economically significant changes in fees on their clients.²⁷ I contacted several auditing partners of Big Four accounting firms whose clients include involuntarily cross-listed firms. None of the partners agreed with the claim that they had raised fees on clients *because* they were involuntarily cross-listed by depositary banks.²⁸ This suggests that IMR's finding that audit fees rose for involuntary cross-listed firms may be due to an increase or change in auditing services, rather than a change in litigation risk.

I also spoke with brokers of directors and officers (D&O) insurance. Firms acquire D&O insurance for executives and board members to indemnify losses and pay for associated legal fees that arise when individuals face litigation in the course of their work for a firm. If litigation risk had significantly increased for firms that were involuntarily cross-listed, the cost of acquiring D&O insurance also ought to have risen.²⁹ Yet, the insurance brokers did not have any knowledge of the price of D&O insurance rising for involuntarily cross-listed firms because of liability considerations arising from the regulatory change.

To summarize, IMR suggest that the market steeply discounted involuntarily cross-listed firms around the passage of the amendment primarily because of the perceived increase in litigation risk. At the same time, at least some sophisticated market participants noted that they never felt there was a significant change in litigation risk to warrant adjustment in their fees.

It is hypothetically possible that the particular auditors, D&O insurance brokers, and attorneys I spoke with could simply be outliers or uninformed about broader, on

²⁷ I also spoke with the executives from several firms that were involuntarily cross-listed. They were also not aware of any increase in per-unit audit fees that arose from being cross-listed.

²⁸ One partner even noted that he looked into this question to decide whether his firm ought to raise rates due to higher litigation risk. His firm found no compelling evidence to justify raising fees on its involuntarily cross-listed clients.

²⁹ Brochet and Srinivasan (2013) examine the litigation faced by individual directors.

average, industry choices.³⁰ Notably, this anecdotal evidence alone does not invalidate IMR's inferences based on large sample empirical data. Nevertheless, these competing and consistent accounts by individuals closely connected to firms affected by the amendment suggest that IMR's narrative ought to be subject to additional scrutiny.

Are there any additional explanations for IMR's results that could help reconcile the apparent decline in firm value they found empirically with the comments of auditors and insurance agents? After reviewing several pieces of additional field evidence, I believe one possible area to explore is the potential selection effect around the type of firm that becomes an unsponsored ADR.

Becoming an unsponsored cross-listed firm is characterized by IMR as "involuntarily." Yet, becoming an unsponsored ADR actually arises indirectly from the decision not to become a sponsored listing. If executives choose to become a sponsored listing, depositary banks are prevented from creating an unsponsored cross-listing. But by avoiding a sponsored cross-listing, depositary banks can cross-list a firm as an unsponsored ADR. Thus, unsponsored cross-listings arise from the managerial decision to *not* become a sponsored listing.

The decision not to become a sponsored listing at a particular point in time conveys information.³¹ Among other changes, managers at cross-listed firms that establish sponsored listings work with their depositary bank to establish proactive investor relations programs (e.g. non-deal roadshows, institutional investor engagement, etc.). Executives who anticipate better firm performance in the future will be more eager to become engaged with investors to grow and diversify their shareholder base. Conversely, executives who anticipate worse performance will be more reluctant and are likely to postpone becoming a sponsored listing.

³⁰ The concentration of auditing services for unsponsored ADR firms primarily among the Big 4 makes it less likely that these comments were unrepresentative of the broader sentiment in the industry. In particular, the lack of litigation risk was expressed by partners from two of the Big 4 firms, reflecting not only their view, but that of their firm. Similarly, D&O brokers intermediate insurance from different firms so their views also represent a wider sample of insurance agents.

³¹ Hail and Leuz (2009) show that firms are more likely to cross-list when they have additional growth opportunities, thereby inflating estimates of Tobin's q around the cross-listing.

Since managers choose when to establish a sponsored listing, it is unsurprising that after establishing a sponsored program, sponsored listings, on average, outperform unsponsored listings. In a study by Oxford Metrica, the authors find that 100 days after converting to a sponsored listing, sponsored cross-listings trade at a 5% premium to unsponsored listings and exhibit a 30% increase in trading.³² These improvements in pricing and liquidity arise from both a selection effect and related investor relations activities that began when firms chose to establish sponsored listings.³³

The improvement in performance for firms that choose to become sponsored creates a problem for IMR's analysis. Their specification only includes firms that choose to remain unsponsored.³⁴ Given that the decision to become a sponsored listing is correlated with firm performance, IMR's analysis is implicitly selecting on the relatively worse performing firms. Thus, the empirically observed value destruction may not arise solely from the firms themselves declining in value, but rather due to selecting on worse performing firms.

IMR are aware of these potential selection issues and conduct a number of additional robustness tests to mitigate the selection problem on observable variables.³⁵ Consequently, it would be premature to conclude that IMR's results arise from a selection effect from this limited discussion. However, the conflicting field evidence still raises several questions that need to be resolved before it would be fair to definitively conclude that involuntarily cross-listed firms faced such a steep value decline due to perceived litigation risk. In particular, the litigation risk seems not to have been explicitly priced by auditors or D&O insurance agents, precisely the individuals that ought to have been able to recognize this risk. The *ex-post* evidence also shows that this risk is low, which is consistent with the *ex-ante* sentiment of auditors and D&O

³² "Building Corporate Reputation: Taking Ownership of Unsponsored Depositary Receipts," Oxford Metrica.

³³ For a discussion of the benefits associated with investor relations see Bushee and Miller (2012).

³⁴ A firm could become sponsored after already becoming unsponsored or in anticipation of becoming unsponsored. It is not known how many firms chose to become sponsored in anticipation of the passage of the amendment.

³⁵ To the extent that selection arises from unobservable variables, that would not be addressed by these tests and ultimately poses a more difficult empirical challenge.

insurance agents. Moreover, IMR's analysis suggests that the aggregate market, unlike auditors and D&O insurance agents, significantly mispriced the litigation risk. Ultimately, if IMR's estimate is accurate and largely driven by litigation risk, why such a significant destruction of value seems to be overlooked by market participants begs to be better understood.

In the end, resolving these conflicting arguments creates an opportunity for future research. Access to D&O pricing data may help elucidate some of the specific determinants of litigation risk. Similarly, internal audit pricing data would further resolve the specific circumstances around when and how clients experience an increase in fees. Additionally, there is more to be understood about the decision to become a sponsored cross-listing. IMR argue that becoming sponsored is a firm's second best strategy after already having been involuntarily cross-listed. However, since executives are rationally bounded, it is not immediately obvious that all firms necessarily made a deliberate cost-benefit calculation to decide the optimal cross-listing choice in anticipation of the amendment (Simon 1997). Further investigation of the managerial decision-making process that leads to different cross-listing choices would contribute to our understanding of this question.

4. Utilizing Field Evidence in Financial Accounting Research

The tenor of IMR's conclusion is decidedly negative- the amendment "did not achieve its intended purpose" and showed how "regulation can be exploited for private gain and result in costly unintended consequences." With such a conclusion, one would expect to find confirmation of the amendment's deleterious consequences by speaking with individuals affected by its passage. Yet, I found surprisingly little affirmation of this sentiment in my conversations with lawyers, issuers, depository banks, investors, and auditors. Most of the individuals I spoke with believed the amendment achieved what it set out to do— increase the accessibility of foreign securities available to U.S investors. This broad sentiment was echoed in other sources of evidence including comment letters, the Federal Register, and legal white papers. Ultimately, the field

evidence collected by direct interaction with constituencies affected by the amendment seems to lead to a less pessimistic narrative than that offered by IMR.

Researchers who rely primarily on publicly-accessible archival data risk overlooking other significant information that can be found by additional field investigation. In an influential set of articles in the management literature, popularly known as the “Honda Effect”, researchers found that examining inferences through the perspective of those directly involved with events can render a significantly different account than one developed by relying on *ex-post* archival data alone (Mintzberg 1996). The research that gave rise to the “Honda Effect” began in the 1970’s when the Boston Consulting Group (BCG) wrote a report that described the demise of the British motorcycle industry. The report identified the superior strategy of Japanese producers, who produced high-volume low-priced motorbikes, as the critical success factor of manufactures like Honda.³⁶

Nearly a decade later, Richard Pascale, a professor at Stanford, interviewed several executives at Honda while researching Japanese management styles. Pascale found that BCG had misinterpreted the narrative underlying Honda and other Japanese manufacturers’ success. Honda had not strategically planned to sell small, inexpensive motorbikes in overseas markets as had been reported by BCG. This strategy only emerged after Honda had failed to make inroads selling its larger bikes. Most surprisingly, executives at Honda only came around to the idea of selling their small bikes after they began to get inquiries from people who saw Honda employees riding around Los Angeles on their personal motorbikes for errands and deliveries. While the widely reported BCG account suggested that Honda had developed a deliberate and successful *ex-ante* strategy, in actuality, Honda’s strategy for its small motorbikes only arose later by happenstance. Pascale offered an explanation for these divergent narratives. “Consultants, academics, and executives express a preference for oversimplifications of reality and cognitively linear explanations of events...We tend to

³⁶ Numerous business schools, including the University of Virginia and Harvard Business School, developed cases studies to teach the model of strategic behavior espoused in the report.

impute coherence and purposive rationality to events when the opposite may be closer to the truth" (Pascale 1984). Pascale dubbed this as the "Honda Effect."

Researchers at BCG had overlooked relevant field evidence. Yet, like BCG, financial accounting researchers often almost exclusively rely on written records that are readily and publicly accessible. With the exception of some survey papers, most financial accounting research is conducted without significant interaction with the actual practitioners involved or associated with the phenomena under examination.

Accounting research is not like chemistry or physics where the construct being studied is not subject to direct inquisition. Often, albeit not always, researchers conducting accounting research can directly solicit responses from the individuals or entities involved with the phenomena. For example, if a researcher wants to understand how auditors responded to a change in regulation, the researcher is not limited to relying on proxies or indirect measurement techniques. The accounting researcher can also directly investigate these changes through field methods beginning with interviews and later use of internal records compiled by auditors or issuers.

Rigor and generalizability are critical attributes associated with high quality research. The aversion among financial accounting researchers to field evidence (e.g. interviewing practitioners, using proprietary data and records, etc.) arises from concern about the lack of verifiable generalizability and perceived biases (e.g. dishonestly, revisionism, etc.). While there are surely limitations of field data, this does not diminish the unique value it can offer accounting researchers who focus on studying institutional-based phenomena. In particular, field evidence can deepen a researcher's understanding of the institutions involved in a phenomenon and also offer the opportunity to validate inferences in a way that is simply not possible when relying on empirical or analytical methods alone.

This argument is not to suggest that interviewing subjects and collecting proprietary data should act as a substitute for large sample analysis or evidence. On the contrary, rigorous empirical research can generate externally valid inferences in a manner that field evidence usually cannot. At the same time, field evidence can uniquely

complement other empirical research methods. This is especially true when field interaction motivates additional and potentially unknown (at least among academics) sources of large sample empirical data. In this way, field interaction with practitioners is not substituting for rigorous empirical research, but rather facilitates an opportunity to deepen a scholar's ability to investigate a phenomenon of interest. It is simply one additional source to consult when developing hypotheses, investigating phenomena, and corroborating inferences.

5. Concluding Remarks

Regulators enact legislation to fulfill a particular objective or set of objectives. Along with fulfilling these objectives, the passage of legislation often creates externalities. Some of these externalities will be anticipated, but others might arise unexpectedly to those who designed and implemented the legislation.

IMR's investigation of the amendment to the Securities Act is ultimately an examination of which effects were intended and which were unexpected externalities of a regulatory change. In contrast to IMR who imply that the growth in unsponsored ADRs was an unexpected and undesirable externality, I present field evidence that suggests that this growth in unsponsored ADR's was explicitly intended by those helping to design the legislation. This distinction is important because it influences our perceptions of regulators' ability to design securities regulation to meet specific goals without creating undue and unexpected externalities.

While archival methods and data have many benefits, certain questions cannot be addressed by appealing to such data alone. Is the magnitude of an effect plausible? Does an empirical proxy accurately capture its underlying construct? These types of questions can often be addressed by appealing to field evidence. In the end, the interpretation of data can avail itself to more than one narrative. Ultimately, by utilizing both archival and field evidence, researchers can eliminate competing narratives to convey the one that most accurately represents all available information.

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Figure 1: Newly Created Unsponsored ADR Programs

Figure 1 shows the number of unsponsored ADR programs created each quarter from October 2008 until June 2013. The date for each unsponsored ADR program corresponds to the creation of the first unsponsored ADR receipt for the foreign issuer. Source data was provided by The Bank of New York Mellon.

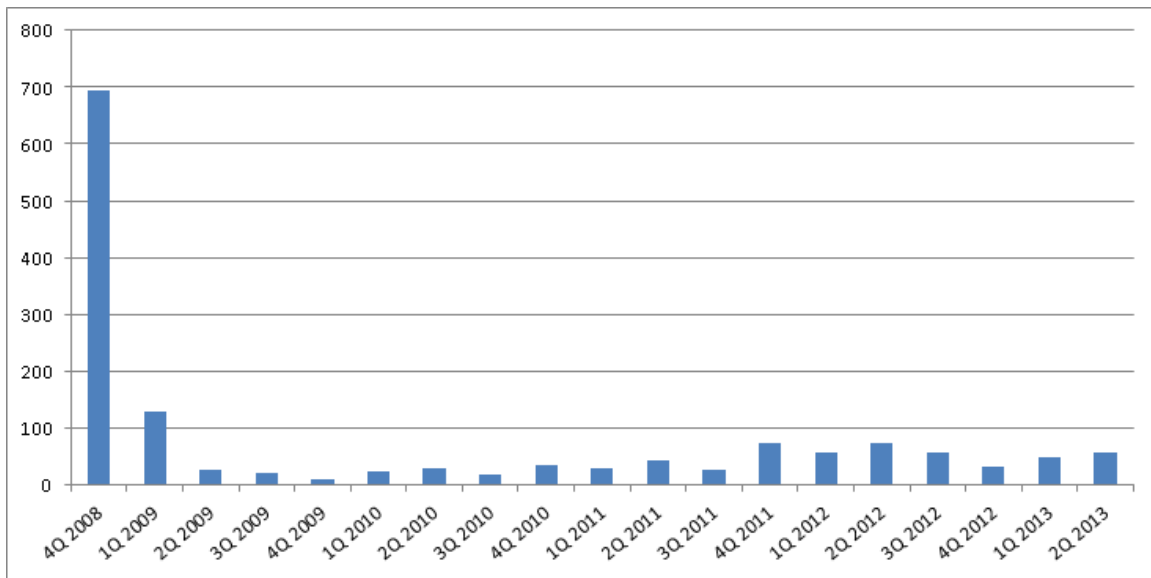


Figure 2: Most Actively Traded Unsponsored ADR's

Figure 2 provides statistics on the monthly trading volume of unsponsored ADR's from July 2012 to July 2013. Panel A shows descriptive statistics on the trading volume for all unsponsored ADRs with available trading data where N=1085 in July 2012 (min. number of securities) and N=1252 in July 2013 (max. number of securities). Panel B shows average monthly trading volume data for the ten most actively traded unsponsored ADR's. Data for the figure was acquired from Interactive Data Corporation.

Panel A

| | Mean | Median | SD | Q1 | Q3 |
|--------------------------------|---------|--------|---------|-------|---------|
| Unsponsored ADR Trading Volume | 283,972 | 20,000 | 863,299 | 1,800 | 188,025 |

Panel B

| ADR Issue | Country | Avg. Monthly Trading Volume |
|--------------------------------|----------------|-----------------------------|
| Li & Fung | Hong Kong | 6,889,836 |
| Finmeccanica | Italy | 4,470,622 |
| Compagnie Financiere Richemont | Switzerland | 3,545,139 |
| Fanuc Corporation | Japan | 3,424,856 |
| Alstom | France | 3,412,632 |
| Electricite de France | France | 3,284,323 |
| Anglo American | United Kingdom | 3,009,081 |
| Cheung Kong | Hong Kong | 2,898,002 |
| Tullow Oil | United Kingdom | 2,691,249 |
| Nintendo | Japan | 2,544,411 |

Figure 3: Institutional Investment in Un-sponsored ADRs

Figure 3 shows the level of institutional ownership of un-sponsored ADRs. The level of holdings is from each institution's most recent Form 13-F filing as of June 2013. Data for the figure was provided by Ipreo.

| Investor Name | Un-sponsored ADR Holdings (\$M) |
|-------------------------------------|---------------------------------|
| Fisher Investments | 2,765.54 |
| Thornburg Investment Management | 2,505.25 |
| Capital World Investors | 2,105.37 |
| Scout Investments | 1,958.92 |
| Dodge & Cox | 1,640.61 |
| The Vanguard Group | 1,338.13 |
| Parametric Portfolio Associates | 1,244.78 |
| Gardner Russo & Gardner Investments | 928.08 |
| Barrow Hanley Mewhinney & Strauss | 875.94 |
| Grantham Mayo Van Otterloo & Co. | 825.86 |