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DO FOREIGNERS INVEST LESS IN POORLY GOVERNED FIRMS?

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ABSTRACT

As domestic sources of outside finance are limited in many countries around the world, it is important to understand the factors that influence whether foreign outside investors provide capital to a country's firms. This study examines whether and why investor concern about corporate governance results in fewer foreign holdings. We use a comprehensive set of foreign holdings by U.S. investors as a proxy for foreign investment and analyze a sample of 4,411 firms from 29 emerging market and developed economies. We find that foreigners invest significantly less in firms that are poorly governed, i.e., firms that have ownership structures that are more conducive to outside investor expropriation. Interestingly, this finding is not simply a matter of a country's economic development but appears to be directly related to a country's information rules and legal institutions. We therefore argue that information problems faced by foreign investors play an important role in this result. Supporting this explanation, we show that foreign investment is lower in firms that appear to engage in more earnings management.

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“The fundamental issue for everyone involved in financial markets today, regardless of company or country, must be to maintain high standards – legal, regulatory, and ethical – that breed trust and confidence. Capital will flee environments that are unstable or unpredictable – whether that's a function of lax corporate governance, ineffective accounting standards, a lack of transparency, or a weak enforcement regime. Investors must see for themselves that companies are living up to their obligations and embracing the spirit underpinning all securities laws.” [William Donaldson, Chairman of the U.S. Securities and Exchange Commission, 2005].

1. Introduction

Domestic sources of outside finance are limited in many countries around the world [Giannetti and Koskinen (2004)]. In response, many capital markets have been liberalized, and foreign capital has become an increasingly important source of finance, particularly for firms from emerging markets [Karolyi (1998)]. For instance, in the mid-1990s Asian firms raised \$1 in foreign equity markets for every \$3 they raised domestically [Bekaert, Harvey and Lumsdaine (2002)]. Given the growing significance of foreign financing, and the fact that access to foreign capital may well be uneven across firms and countries, it is important to understand more fully the factors that can cause investors to shy away from providing capital to foreign firms.

Poor firm-level corporate governance is one factor that draws considerable attention from outside investors and regulators, but has rarely been investigated in large-scale academic studies. Institutional investors frequently claim that they avoid foreign firms that are poorly governed, particularly when it comes to investments in emerging markets.¹ Similarly, as the quote above makes clear, government officials and securities regulators often express concerns that poor governance hinders foreign investment and may thus impede financial development. However, outside investors that fear governance problems and expropriation by insiders are likely to

¹ A 2002 McKinsey and Company global investor survey shows that corporate governance considerations dominate decisions about which firms in Latin American and East Asia receive investment whereas for North American firms financial statement considerations dominate. The survey also reports that “more than 60% of investors state that governance considerations might lead them to avoid individual companies with poor governance.” Similarly, when discussing investment criteria, the long-time manager of the \$1.2 billion Templeton Developing Markets Trust, Mark Mobius, states that “corporate governance is not improving, so why fight it?” [Karmin (2000)].

reduce the price they are willing to pay for a firm's shares. As a result of price protection, even poorly governed firms should offer an adequate return, raising the questions of whether and why governance concerns could manifest themselves in fewer foreign holdings.

Our study is an attempt to shed some light on these questions examining a sample of 4,411 firms from 29 countries in which U.S investors are the "foreign" investors. We show that U.S. investors, which comprise about half of all foreign investment worldwide, do in fact hold fewer shares in non-U.S. firms with ownership structures that are more conducive to governance problems and expropriation by controlling insiders. We also provide evidence that information problems faced by U.S. investors play a central role in this result.

It is commonly argued that foreign investors are at an informational disadvantage relative to local investors [Brennan and Cao (1997), Kang and Stulz (1997), and Choe, Kho, and Stulz (2005)]. In this paper, we argue that information asymmetries between foreign and local investors are particularly pronounced with respect to the evaluation of a firm's governance structures. In many countries – constituting both emerging and developed markets – business transactions, financing arrangements, and, ultimately, corporate governance are shaped not by arm's length dealings, but by relationships among a tightly knit group of controlling families and managers. Understanding these insider relationships (and their implications for outside investor expropriation) requires an intricate social knowledge of political connections, banking connections, private gatherings of the business elite, and so forth, which foreigners are less likely to have. Additionally, it seems plausible that foreign investors are more likely to shy away from particular firms with expected insider expropriation problems when a country's governance and information regulations are relatively weak, because poor country-level institutions make the evaluation of firms' governance structures more important and costly.

These information asymmetries can influence the investment decisions of foreign investors in two ways. First, they give rise to an adverse selection problem when investors transact in foreign markets [Akerlof (1970) and Milgrom (1981)].² As a result, investors underinvest in foreign stocks because they do not expect to receive a fair return based on the prices at which locals would transact. Consistent with this reasoning, Choe, Kho, and Stulz (2005) find that for Korean stocks prices move more against foreign investors than domestic investors before trades. Second, once an investment is made, firms with suspect governance structures require more monitoring than well-governed firms and, based on our preceding arguments, this is likely to be more costly for foreign investors. In addition, poorly governed firms often actively hide the extent of their governance problems and expropriation activities, for instance, by providing opaque financial statements and managing earnings [e.g., Fan and Wong (2002) and Leuz, Nanda and Wysocki (2003)]. Again, local investors are probably better equipped to unravel these activities, resulting in lower monitoring costs.

Stulz (1981) shows in an equilibrium model that out-of-pocket costs incurred in holding foreign assets can induce investors to underweight foreign securities. While Stulz (1981) models these costs as a tax that equally affects all foreign holdings of domestic investors, his basic insight can be extended to the situation we describe above, in which information costs related to governance differ across investors, firms, and markets [see Cooper and Kaplanis (1986, 2000) for such model extensions]. These papers form the theoretical basis of our argument that, in capital market equilibrium, governance structures that are particularly taxing with respect to their information and monitoring costs can manifest themselves in lower foreign holdings.

² The fundamental problem is very similar to the one that motivates bid ask spreads and price impact of trades in the market microstructure literature. See, e.g., Glosten and Milgrom (1985) and Kyle (1985).

As there can be a host of reasons why foreign investors avoid or seek stocks from a particular country, such as the degree of market integration, benefits from diversification, transaction costs, restrictions on capital flows, proximity to the home country, and language, we control for country-fixed effects in our tests. That is, we analyze which stocks U.S. investors choose within a given country, focusing on ownership structures that are more conducive to governance problems and expropriation of outside investors.

We obtain U.S. holdings by merging comprehensive security-level data on all U.S. investors' positions in non-U.S. equities from the 1997 U.S. Treasury and Federal Reserve Board benchmark survey. We identify poor firm-level governance by constructing both nominal and relative proxies indicating that managers and their families are, in effect, in control of their firms. As managers and families generally obtain control by owning far less than 100% of a firm's cash flow rights, controlling insiders have not only the ability but also the incentive to expropriate outside investors [Jensen and Meckling (1976) and La Porta, Lopez-de-Silanes, and Shleifer (hereafter LLS) (1999)].³ We obtain our ownership and control data from Claessens, Djankov, and Lang (2000) (Japan), Faccio and Lang (2002) (Western Europe), and Lins (2003) (emerging markets) and combine these datasets in a consistent fashion.

Across all countries, we find that firm-level proxies for governance problems and private control benefits have a negative relation to U.S. investment, but the result is relatively weak in terms of both economic and statistical significance. We next analyze the effect of poor governance on U.S. holdings within emerging market economies because it is often argued that access to foreign capital is particularly important for these firms and for these economies overall [Henry (2000), Bekaert, Harvey, and Lundblad (2001, 2005)]. We find that firm-level proxies

³ Supporting this hypothesis, Claessens, Djankov, Fan, and Lang (2002), Lemmon and Lins (2003), and Lins (2003) show that in emerging markets high levels of managerial and family control are costly to non-controlling or outside shareholders.

for governance and expropriation problems are unrelated to U.S. holdings in this context. While seemingly surprising, the classification of countries as “emerging markets” based on per-capita GDP does not account for the substantial variation in countries’ institutional structures. There are developed market countries, such as Italy, for which Zingales (1994) provides evidence that opaque reallocations of assets to favor connected insiders at the expense of minority shareholders are easily tolerated within the country’s institutional and political framework. In contrast, there are emerging markets such as Hong Kong that have relatively comprehensive and well-enforced disclosure requirements, such as those on related party transactions as documented by Cheung, Rau, and Stouraitis (2005). Similarly, a country’s domestic supply of arm’s-length finance is not simply a function of its economic development. In Germany, one of the largest economies in the world, finance has traditionally been more relational than arm’s length.

We expect the governance effect on holdings to be more pronounced in countries whose institutional structures exacerbate the information problems faced by foreign investors. To examine this hypothesis, we conduct tests that estimate the governance effect on foreign holdings separately for countries with low and high scores for measures from LLS (2004) that capture a country’s disclosure regulation and outside investor protection. Our results indicate that weak country-level disclosure and governance, rather than a country’s GDP-per-capita, makes firm-level governance an important determinant of foreign investment. U.S. investors significantly underweight firms with high levels of managerial and family control when they are domiciled in countries with weaker disclosure requirements, securities regulations, and outside shareholder rights, or domiciled in countries with a non-English legal origin, which is often argued to be a summary measure for a number of institutional features. In contrast, within extensive-disclosure

and strong-governance countries, firms with high levels of managerial and family control do not experience less foreign investment.

These results are consistent with an interpretation that information problems faced by foreign investors for firms with poor firm-level governance play an important role in investment choices. Stringent disclosure requirements make it less costly to become informed about potential governance problems and they also level the playing field among investors so it is less likely that locals have an information advantage. Strongly enforced minority shareholder protection reduces the consumption of private benefits of control and thus decreases the importance of information regarding these private benefits. In contrast, low disclosure requirements and weak investor protection exacerbate information problems.

An alternative and potentially more direct way to test whether information problems are at the core of our holdings results is to use proxies for poor information flows instead of our governance variables. Leuz, Nanda, and Wysocki (2003) and Haw, Hu, Hwang, and Wu (2004) show that earnings management is more pervasive in countries with weak investor protection, and in firms where insiders are more likely to consume private control benefits. These findings support the notion that information flows to outside investors are particularly poor for firms with weak governance. Thus, we replace our firm-level governance variables with firm-level earnings management proxies and re-estimate our models to see whether these proxies yield similar results. Consistent with our hypothesis, we find that foreign holdings of U.S. investors are negatively related to the presence of firm-level earnings management in countries with weak disclosure requirements, securities regulation and outside shareholder protection. This finding sheds some light on the mechanism behind our earlier results and lends further credence to the notion that information problems associated with poor governance deter foreign investment.

Our paper has two main contributions. First, we are the first to provide compelling evidence for a large sample across many countries that foreigners do indeed invest less in poorly governed firms. As discussed in more detail in the next section, prior studies are limited by their samples and have produced mixed results. Second, we take the analysis a step further and show that the governance effect on foreign holdings owes at least in part to information problems. This conclusion is supported by the finding that the foreign holding effects are particularly pronounced for poorly governed firms in countries with weak governance and disclosure regulation, and the finding that foreign holdings are negatively associated with higher levels of earnings management in weak governance and disclosure countries.

The remainder of the paper is organized as follows. Section 2 discusses the empirical literature on international portfolio holdings, particularly as it relates to information and governance problems. Section 3 describes our data and sample selection. Section 4 presents the empirical findings. Section 5 concludes.

2. Discussion of Prior Findings

Prior studies on corporate governance and foreign investment can be divided into those based on aggregate, country-level portfolio data and those that utilize firm-level data. Country-level results are somewhat mixed. Both Chan, Covrig, and Ng (2004) and Dahlquist, Pinkowitz, Stulz, and Williamson (hereafter DPSW) (2003) study a combination of emerging and developed market countries and find that of a battery of country-level governance variables, only a proxy for government expropriation risk matters.⁴ However, the two studies obtain the opposite results; international investors prefer countries with a lower government expropriation risk in

⁴ Overall, DPSW conclude that ‘for a given supply of shares, U.S. investors do not invest less in a country because minority shareholders are less well protected or because laws are not enforced’ (page 104).

DPSW, but avoid such countries in Chan et al. In contrast to the Chan et al. finding, Giannetti and Koskinen (2004), using the same source data on holdings, find that funds put a larger share of their assets in countries with better scores for private enforcement of investor rights. Two related studies focus exclusively on emerging markets. Aggarwal, Klapper, and Wysocki (2005) find that U.S. mutual funds overweight emerging markets that have stronger accounting standards, shareholder rights and legal frameworks, and Gelos and Wei (2005) find that less opaque emerging market countries have greater weights in mutual funds' portfolios.

Firm-level results are also mixed. To our knowledge, tests that incorporate firm-level governance proxies obtained from ownership structures have been conducted only for Sweden and show conflicting results. DPSW find no evidence that firm-level ownership matters to foreign investors, whereas Giannetti and Simonov (2006) find that foreign investors are less likely to invest when a firm's controlling shareholders have greater incentives to expropriate outside investors. It can be argued that another firm-level indicator of strong governance is the presence of a U.S. exchange listing (see, among others, Foerster and Karolyi (1999), Miller (1999), Lang, Lins, and Miller (2003), Doidge, Karolyi, and Stulz (2004), and Doidge, Karolyi, Lins, Miller, and Stulz (2005)), although this event occurs for only a very small percentage of all publicly traded non-U.S. firms. Ammer, Holland, Smith, and Warnock (2004), Bradshaw, Bushee, and Miller (2004), Edison and Warnock (2004), and Aggarwal, Klapper, and Wysocki (2005) find that a U.S. listing is associated with a substantial increase in foreign investment.⁵

While extant country-level regressions such as DPSW (2003) do not find a link between governance and foreign investment once a firm's free float is controlled for, these findings do not necessarily imply that such a link does not exist. It is possible that foreign investors overweight

⁵ Cross listing is also argued to proxy for both an international presence and a lessening of direct and indirect barriers to international investment (Pagano, Roell, and Zechner (2002), Claessens, Klingebiel, and Schmukler (2003), and Sarkissian and Schill (2004)), both of which should contribute to increases in foreign holdings.

firms for which governance is expected to be strong (e.g., those with U.S. cross listings) and underweight firms with weak governance, resulting in no effect in the aggregate. Alternatively, the country-level governance measures used in previous work could be too coarse to pick up the effect. One reason why previous studies using firm-level governance variables yield inconsistent results could be the fact that they have been conducted for Sweden – a country with relatively strong governance [DPSW (2003) and Giannetti and Simonov (2006)]. Strong external governance is known to lessen the impact of potential firm-level governance problems [Lins (2003), Nenova (2003), Doidge (2004), Dyck and Zingales (2004), and Klapper and Love (2004)].⁶ Thus, a more thorough understanding of corporate governance and foreign investment calls for tests that discriminate, within country, based on firm-level governance parameters and do so for a wide range of countries to exploit country-level variation in corporate governance. We conduct such tests in this paper.

Indeed, our investigation of corporate governance and foreign holdings is unique because we combine data on a large number of firms that have wide variation in both firm- and country-level governance parameters with a comprehensive dataset on foreign holdings of these firms. Prior empirical work on this topic has been hampered by data limitations because comprehensive data on governance and outside holdings are hard to obtain at the firm level. In addition, our paper illustrates that it is important to consider both firm and country factors in explaining whether and why foreign investors shy away from poorly governed firms.

⁶ For additional evidence on firm-level and external corporate governance see surveys by Claessens and Fan (2002) and Denis and McConnell (2003).

3. Sample Selection and Variable Construction

3.1 A Firm-Level Measure of the Foreign Holdings

We design our tests to investigate foreign holdings through the eyes of U.S. investors. In particular, we use a mandatory and confidential survey conducted by the U.S. Treasury Department and the Federal Reserve Board⁷ of the holdings of all U.S. investors as of December 1997 to obtain our foreign investment proxy: the percentage of a firm's free float that is held by U.S. investors. A more ideal dataset would be a matrix of the security-level investment from each country into the firms of all other countries, but such a matrix does not exist because so few countries collect security-level cross-border holdings data. The limitation of including only U.S. investors' holdings should not be particularly troubling since these investors collectively hold 47% of the world's international equity positions.⁸ While the typical U.S. investor who ventures abroad is an institution, our data include foreign equity holdings by all types of U.S. investors and in all types of foreign equities; specifically, they are not limited to institutional holdings of U.S.-traded securities, as are the data contained in SEC 13-f filings.

It is important to note that, unlike many papers in this literature, we scale U.S. holdings by *float* (the percentage of shares not held by 5 percent or greater blockholders). Scaling by market capitalization – the usual technique – could mechanically produce a negative relation between governance and foreign holdings, given that our governance measures are derived from insider holdings. Poorly governed firms would have fewer shares available to outside investors and would naturally have less outside investment. Scaling by float is more conservative and avoids potentially hardwiring the results.

⁷ For a primer on the surveys, see Grier, Lee, and Warnock (2001). Publicly available country-level data—formed by aggregating the confidential security-level data used here—have been analyzed in Ahearne, Grier, and Warnock (2004) and DPSW. The security-level data have been studied by Ammer, Holland, Smith, and Warnock (2004) and, using a more limited sample, Edison and Warnock (2004).

⁸ Of the \$2.6 trillion in international equity positions reported to the IMF-led 1997 Coordinated Portfolio Investment Survey, U.S. investors held \$1.2 trillion.

3.2 Firm-level Corporate Governance

Our main hypothesis is that information problems are likely to play a major role, if in fact foreign investors avoid poorly governed firms. Specifically, we maintain that foreign investors are at an informational disadvantage relative to local investors and that information asymmetries are particularly pronounced when it comes to evaluating firms' governance structures. In many countries around the world, financing arrangements and corporate governance are based on relatively opaque relationships, rather than arm's length dealings. Ownership structures are quite concentrated and families control many businesses. Understanding the relationships that govern firms and the motives of families and large owners requires an intricate social and institutional knowledge, which many foreigners lack or find costly to obtain. Put differently, poorly governed firms are particularly taxing to foreign investors in terms of their information and monitoring costs.

To examine whether U.S. investment is related to firm-level corporate governance, we obtain ownership and control structure data for Western European firms from Faccio and Lang (2002); for emerging market firms from Lins (2003); and for Japan from Claessens, Djankov, and Lang (2000). Ownership and control data for Japanese and emerging market firms are from the 1995/1996 period and those from Western Europe range from 1996 to 1999, with the majority of sample observations occurring in 1996.⁹ We confine our analysis to non-financial firms to maintain consistency across the three ownership and control structure datasets. Claessens, Djankov and Lang (2000), Faccio and Lang (2002), and Lins (2003) report ownership

⁹ The Treasury/Federal Reserve data on U.S. holdings is compiled for year-end 1997 and 1994. Because our ownership data are predominantly from 1996, we use the 1997 data in our tests to obtain the best contemporaneous match. For robustness, we re-estimate our models using the more distant-in-time 1994 U.S. holdings data and find that our results are qualitatively similar.

and control statistics for various types of blockholders. For instance, all three studies report the percentage of total ultimate control rights held by Family/Management, Government, Widely-Held Corporations, Widely-Held Financials, and Miscellaneous (which includes ownership by Trusts, Cooperatives, Foundations, Employees, etc.).

In constructing our firm-level governance proxies, we focus on managerial and family control rights because it is the management group (and their families) that actually makes the operational and financial decisions of a firm and it is these decisions that potentially expropriate outside investors. We seek to construct measures that indicate that a family or a firm's management is effectively in full control of the firm because, all else equal, insiders' ability to expropriate minority shareholders will be highest when their control of a firm cannot be challenged by other blockholders or groups of shareholders (e.g., institutional investors).

As effective managerial control depends on the control rights held by management as well as the control rights held by outside blockholders, we use both nominal and relative measures of effective managerial control in our analysis. The nominal one is the percentage of control rights held by the management group and its family, with the idea that higher levels of managerial control correspond to more effective control of a firm. The relative measures capture the idea that high percentage levels of control are not always necessary to establish effective managerial control and to prevent interference by other blockholders. Our three relative measures of effective managerial control are indicator variables set equal to one when Family/Management control rights exceed: 1) the median level of Family/Management control rights of all sample firms in the country; 2) the median level of Family/Management control rights of all sample firms in the country as well as the control rights held by any other

blockholder in the firm; or 3) 50% of the total outstanding shares of a firm. Of these relative measures, the 50% control threshold is the strongest measure of effective managerial control.

In our models, we also analyze the importance of non-management blockholdings by using the percentage of control rights and an indicator variable for non-management control above 50%. These tests can be viewed as a robustness check that assures us that we do not simply pick up the effect of concentrated holdings, and that it is, in fact, managerial and family control that drives our findings.

We note that, in many cases, our firm-level governance proxies also capture a separation of managerial control and cash flow rights. To the extent that effective managerial control can be established at some level below 100% cash flow rights ownership, control and cash flow rights will be inherently separated. Generally, managerial control of 51% of a firm's shares will confer unequivocal control rights. Given the lack of active corporate control markets in most sample countries as well as laws in some countries that grant special privileges to large but not necessarily majority blockholders (e.g., Germany), effective managerial control can often be obtained with substantially less than 51% control, driving a further wedge between control and cash flow rights. But even in the 51% control case, controlling managers that divert one dollar from the firm for personal gain will bear at most 51 cents of the cost, giving rise to various managerial agency problems [e.g., Jensen and Meckling (1976)]. In this sense, our proxies not only capture the ability but also the incentives of controlling insiders to expropriate outside shareholders and to consume private control benefits.¹⁰

To explicitly compute the wedge between control and cash flow rights, we would need to observe the ultimate cash flow ownership stakes held by the management group and its family

¹⁰ While we do not have data to separate the effect of managerial cash flow rights from control rights in our full sample, the analysis in Faccio and Lang (2002) and Lins (2003) suggests that, for our sample, ultimate managerial control rights often exceed cash flow rights because of pyramid ownership structures and superior voting shares.

for all of our firms. Unfortunately, the cash flow ownership data presented in Faccio and Lang (2002), Lins (2003), and Claessens, Djankov and Lang (2000) are categorized using different algorithms, which makes it difficult to construct a consistent measure across datasets. Faccio and Lang and Claessens et al. report the separation of ownership and control for the largest blockholder of their sample firms (which may not be the Family/Management group), while Lins reports this measure for all holdings of the Family/Management group (which may not be the largest blockholder). Given these difficulties, we focus on the control rights held by the management group and its family since this measure can be consistently identified for all sample countries. However, relative to the wedge that is implicit in the construction of our control proxies, any further separation of control from cash flow rights via pyramids and superior voting shares may be a second order effect.¹¹

3.3 Country-level Corporate Governance and Information Parameters

Our hypothesis focuses not only on expected governance problems at the firm level, but also on country-level differences in governance and information flow. We expect that information problems faced by foreign investors are more prevalent in countries with weak disclosure and securities regulation as well as weak governance rules. The idea is that disclosure rules level the playing field among investors and make it easier to obtain information to evaluate firms' governance structures. Strict and well-enforced governance rules make knowledge about private control benefits and expropriation less important.

In our analysis, we employ several of the variables that are frequently used in the international literature on stock market development and corporate governance. First, we use the

¹¹ Consistent with this conjecture, we find (in untabulated tests) that the ratio of control to cash flow rights for the largest blockholder from Faccio and Lang (Western Europe) and Claessens et al. (East Asia) is insignificant when we include it in our models in addition to our managerial and family control proxies.

Disclosure Requirement values reported in Table 2 of LLS (2004). We differentiate between low and high disclosure countries based on whether a country is below or above our sample median score of 0.75 on the Disclosure Requirement measure. We expect that foreign investors will have less of an information disadvantage in high disclosure countries. Second, we follow Hail and Leuz (2004) and combine the LLS (2004) Table 2 measures of Disclosure Requirements, Liability Standards, and Public Enforcement into a measure called Securities Regulation. This measure is a comprehensive indicator of disclosure rules and their associated enforcement, both of which should serve to reduce the private benefits of control and thus reduce the importance of information regarding these benefits. We expect that foreign investors will suffer less from information problems when Securities Regulation is relatively high. Our high Securities Regulation subsample consists of countries that score above our sample median score of 0.58. Third, as an institutional summary measure and a proxy for shareholder protection, we classify non-English legal origin countries as low protection because La Porta, Lopez-de-Silanes, Shleifer, and Vishny (hereafter LLSV) (1997, 1998) suggest that countries with a traditional English legal origin tend to provide stronger investor protections. Fourth, we use the index for Antidirector Rights in LLSV (1998) and classify countries with Antidirector Rights below 4 as low protection countries and those with scores equal to or above 4 as high protection countries.

Finally, because many emerging market liberalization studies make the point that attracting foreign capital is particularly important (as these countries often have relatively weak institutions), we segment countries based on whether they are classified as having emerging markets by *The Economist* magazine as of December, 1997. This classification primarily takes into account a country's GDP-per-capita, but also considers the strength of various institutions within the country.

3.4 Sample Selection and Summary Statistics

We combine the firm-level control structure data presented in Faccio and Lang (2002), Lins (2003), and Claessens, Djankov and Lang (2000), resulting in 6974 firms. We exclude 976 financial firms. We obtain financial variable data (used in regressions) and float data from the Worldscope database for the year-end closest to December 31, 1997 as our U.S. holdings data are from that point in time and it closely corresponds to the date of our ownership and control data; these data are not available for 1587 firms.¹² Our final sample consists of 4411 firms.

Table 1 provides summary statistics for our sample based on a firm's country of domicile. Our sample, which includes firms from 29 countries, is concentrated in Europe (2469 firms) and Asia (979 Japanese firms and another 800 from Emerging Asia), with relatively few (61) Latin American firms.

The second column of Table 1 present mean levels of U.S. investment as a percent of float. In our sample, U.S. investors hold on average 6.4% of the available float. U.S. ownership is highest in Latin America, particularly Argentina,¹³ and lowest in Asia. The third column of Table 1 shows that our firms are quite large overall, with mean assets of 1.75 billion U.S. dollars.

Columns 4 through 7 detail blockholder statistics for our sample. For the median firm, Family/Management group control is 13%, with wide variation across countries. The median of the control rights held by blockholders other than the Family/Management group is 5%, with a similarly wide variation in this parameter across countries. The table shows that the Family/Management group is by far the dominant type of controlling blockholder.

¹² When calculating a firm's float, we adjust Worldscope data in two ways. First, we correct the closely-held variable by subtracting the amount that Worldscope erroneously attributes to depository banks. Second, so that float is measured at the same time as U.S. holdings, we utilize price data from Datastream to convert Worldscope's fiscal year-end data to calendar year-end. See AHSW for details.

¹³ Argentina's median holdings are high because most of its firms in our sample are cross-listed. Removing all cross-listed firms would change summary statistics but would not alter our main results.

Family/Management group control rights exceed those of any other blockholder for 53% of the sample¹⁴ and exceed 50% of total control rights in 22% of sample firms.

4. Empirical Tests and Results

4.1 Construction of the Empirical Model

Firms with substantial insider holdings will almost surely have narrower total shareholder bases, as fewer shares are available to outside investors. We are interested in assessing whether there is an additional effect of corporate governance on the shareholder base above and beyond this supply effect. To control for this effect, we exclude shares tied up by insiders and other large blockholders and define our proxy for foreign investment as the proportion of firm i 's float that is held by U.S. investors:

$$USInvestment_i \equiv \frac{USHoldings_i}{Float_i} \quad (1)$$

While it is crucial to account for a firm's float in our tests, scaling by float mechanically biases our results *against* finding a significant negative relation between Family/Management control and U.S. investment.¹⁵ This bias occurs because an increase in Family/Management control reduces the available float. If U.S. investment does not change, U.S. investment as a percentage of float nonetheless increases. Thus, to the extent we find that Family/Management control is negatively related to U.S. ownership as a share of float, the inference that poor

¹⁴ For 127 firms, we are unable to unambiguously identify the largest blockholder, so these firms are dropped from tests using this indicator variable.

¹⁵ We also note that in general not all of a firm's float is held by foreigners. Estimates based on data contained in Ahearne, Grier, and Warnock (2004), DPSW (2004), and the International Monetary Fund 1997 Coordinated Portfolio Investment Survey suggest that about 30% of the world float is held by foreigners. Thus, our tests are unlikely to merely reflect shifts from one group of foreign investors to another.

expected governance negatively impacts the foreign investor base – above and beyond the direct effect through limiting the float – will be particularly robust. Conversely, any positive effect between U.S. investment and our blockholder control variables has to be interpreted cautiously. We illustrate this effect by also providing results scaling U.S. holdings by a firm’s market capitalization and controlling for free float on the right-hand side.

In our analysis, the primary variables of interest are the control structure variables that proxy for expected firm-level corporate governance. Before directly assessing these variables, it is important to control for a firm’s size, leverage, growth prospects, and international presence, because prior studies show that these factors are related to portfolio investment levels. Kang and Stulz (1997) and Dahlquist and Robertsson (2001) document that foreign investors in Japan and Sweden avoid small, highly levered stocks that do not have an international presence, possibly because information about them is less readily available. Consistent with this interpretation, Coval and Moskowitz (1999) find that the local bias is greater for such firms. Foreign investors in Japanese and Swedish equities also show a preference for growth stocks.

We control for *Size*, calculated as the log of total assets converted to thousands of U.S. dollars, and for *Leverage* using the ratio of total debt to total assets. Firms with higher leverage are more financially vulnerable and, thus, might attract less outside investment. This variable is also important as a governance control because Harvey, Lins, and Roper (2004) find that leverage can mitigate the value loss associated with firm-level agency problems. We include a cross-listing dummy variable, *XLIST*, that takes the value of one if the firm is listed on a U.S. exchange as a proxy for both an international presence and a lessening of direct and indirect

barriers to international investment.¹⁶ For similar reasons, we also control for a firm's inclusion in the MSCI World Index.

We include two proxies for growth in our models. *Book-to-market*, calculated as the book value per share over the year-end market price, is included because a preference for growth stocks can be reflected in a tendency to hold low book-to-market value stocks. *Dividend Yield*, calculated as dividends per share over the year-end market price, could be related to growth if firms with better growth prospects pay lower dividends as they plow revenues back into the firm. If U.S. investors prefer growth stocks and these two measures capture growth opportunities, we would expect to see a negative relation between each measure and U.S. holdings. However, low dividend payments by non-U.S. firms could also represent expected firm-level governance problems (LLSV (2000) and Kalcheva and Lins (2005)) in which case dividend yields could be positively related to U.S. holdings if U.S. investors seek to avoid firms with poor expected governance. Because investors often favor certain industries, we include industry-fixed effects (based on the groupings in Campbell (1996)). We include country-fixed effects in our models because singular country-level variables for disclosure, legal origin, etc., are unlikely to capture all relevant institutional differences across countries (e.g., both Hong Kong and the U.K. have English legal origin, yet their ownership structures could not be more different).

Although more than 75% of the firms in our sample are held by at least some U.S. investors, the non-trivial number of firms with zero U.S. holdings prompts us to utilize a Tobit regression model. Specifically, we estimate Tobit regression models of the following form:

¹⁶ A firm's foreign sales, another measure of international presence, has poor coverage in Worldscope, so we follow Dahlquist and Robertsson (2001) and utilize a cross-listing variable. As we note earlier, cross listing can also proxy for improved governance and information flow.

$$\begin{aligned}
\text{U.S. investment} = & \beta_0 + \beta_1 \text{Managerial and Family Control} + \beta_2 \text{XLIST} + \beta_3 \text{MSCI} \\
& + \beta_4 \text{Firm Size} + \beta_5 \text{Leverage} + \beta_6 \text{Book to Market} + \beta_7 \text{Dividend Yield} \\
& + \beta_8 \text{Country Controls} + \beta_9 \text{Industry Controls}
\end{aligned} \tag{2}$$

where U.S. investment is U.S. holdings as a percentage of available float and the Managerial and Family Control variables are the percentage of Family/Management control rights; an indicator variable set equal to one if the Family/Management group's control rights are greater than the median value of the control rights held by the Family/Management group for all firms in its country; an indicator variable set equal to one if the Family/Management group's control rights are greater than the median country value *and* the Family/Management group is the largest blockholder of control rights; and an indicator variable set equal to one if Family/Management has majority (i.e., >50%) control rights, respectively. For comparison purposes, we also use the percentage of control rights held by Other (i.e., non-Family/Management) blockholders or an indicator that Other blockholder control rights exceed 50%.

4.2 Firm-level Corporate Governance Results

The important contribution of this paper is to further advance our understanding of corporate governance and foreign investment by conducting tests that discriminate within country based on firm-level governance parameters, and that do so for a wide range of countries.

Table 2 reports the coefficients of Tobit models estimated on our full sample of 4411 firms from 29 countries. Model 1 of Table 2 tests our nominal measure of effective managerial control. The model shows that after controlling for other factors, an increase in the control rights held by the Family/Management group corresponds to a decrease in U.S. investment. The 25th percentile for Family/Management control is zero and the 75th percentile is 44%. The coefficient

of -0.018 (significant at the 5% level) indicates that, all else equal, a firm in which Family/Management control changes from the 25th to the 75th percentile would have U.S. investment (as a share of market capitalization) that is 0.8 percentage points lower.

In Models 2 through 4 we use progressively more stringent relative measures of Family/Management control. Results for the second and third models show insignificant coefficients on a dummy variable for above-median Family/Management control and a dummy variable for the combination of above-median Family/Management control and the Family/Management group being the largest blockholder. Only the strongest relative measure of control – a dummy for Family/Management control above 50% – is significantly negatively related to U.S. investment. Model 4 shows that majority Family/Management control rights are associated with a -0.83 percentage point reduction in U.S. investment (significant at the 10% level). The fifth and sixth models show that the control held by all blockholder types other than the Family/Management group is not significantly related to U.S. investment. This lack of significance is comforting in the sense that it highlights that our results are driven by ownership structures that are more likely to give rise to governance concerns, rather than ownership concentration per se. The latter category includes a wide range of blockholders and there is less of a reason to expect that these outside blockholders have the ability to consume significant private benefits of control or to distort information flows.

We also note that control variables included in the models show signs consistent with expectations. U.S. investment is higher in firms that are cross-listed on a U.S. exchange or are in the MSCI World Index, and are larger. U.S. investment is lower in firms that have higher leverage and higher book to market ratios. The coefficient on dividend yield is generally not significantly different from zero.

Taken together, the significant results in Table 2 for our two strongest measures of Family/Management control provide moderate, but not overwhelming, support for the hypothesis that the presence of potentially high private benefits of control at the firm level dissuades equity investment by foreign investors.

4.3 Firm-level Results Segmented by Country-level Parameters

We mention at the outset of this paper that increased access to foreign capital is thought to be particularly important for firms from emerging markets. As such, we next test whether poor firm level governance is significantly related to foreign investment in the subset of our sample countries that constitute emerging markets. Table 3 reports the results of these model estimations for the 1017 emerging market firms from our sample. We find in Models (1) through (4) that firm-level proxies for governance problems and expropriation are not significantly related to U.S. holdings in emerging markets (and Models (5) and (6) show that non-inside blockholdings remain unrelated as well). While the Family/Management control results seems to go against prevailing intuition, the classification of countries as “emerging markets” based primarily on per-capita GDP does not account for the substantial variation in countries’ institutional structures as they relate to disclosure, shareholder protection, and legal enforcement.

Empirical evidence across a range of emerging markets shows that insiders’ private control benefits are particularly high when countries’ shareholder protections are the weakest [Lins (2003) and Klapper and Love (2004)]. Variation in private control benefits is found across developed countries as well, and it is again the institutions that matter [Nenova (2003), Doidge (2004), and Dyck and Zingales (2004)]. In a similar vein, Lang, Lins, and Miller (2004) show

that the combination of firm- and country-level governance problems has particularly negative implications for a firm's analyst following and information environment. Our information argument suggests that information problems for foreign investors are particularly pronounced when both firm-level governance and country-level institutions are weak – thus, a more fundamental test of our hypotheses will take account of particular country-level parameters related to information flow and governance. It follows that foreign investors are likely to invest less in countries where information flow and governance is poor. But, given that investors want to invest in a certain country for portfolio diversification reasons, they are likely to pick those stocks for which information asymmetry problems should be the smallest.

To capture this interplay between firm- and country-level governance and information flow effects, beginning with Table 4 we re-estimate our previous regressions, partitioning the sample based on our country-level governance and information flow proxies: Disclosure Requirements, Securities Regulation, Legal Origin, and Antidirector Rights. Our previous full sample tests and emerging markets subsample tests did not explicitly segment countries on the basis of these underlying institutional factors. Meaningful cross-sectional variation in the effect of the control structure variables also alleviates potential concerns that our previous findings are driven by correlated omitted variables.

Table 4 presents the association between our firm-level governance proxies and U.S. investment based on Disclosure Requirements. Panel A reports results for our low Disclosure Requirements subsample comprised of countries whose score is below our sample median score of 0.75. Model 1, which tests our nominal measure of effective managerial control, again shows that an increase in the control rights held by the Family/Management group corresponds to a decrease in U.S. investment, but the negative coefficient is much larger and more significant than

it was in the all-country model estimated in Table 2. The 25th percentile for Family/Management control in this subsample is zero and the 75th percentile is 49%. The coefficient of -0.041 indicates that, all else equal, a firm in a low shareholder rights country for which Family/Management control changes from the 25th to the 75th percentile would have U.S. investment (as a share of float) that is 2 percentage points lower, an economically significant amount given that average U.S. investment is 6.4%.

Results for the second, third, and fourth models – which use relative measures of Family/Management control – are similarly strong in magnitude and significance. For example, Model 4 shows that majority Family/Management control rights are associated with a 2.3 percentage point reduction in U.S. investment. As before, the fifth and sixth models show that the control held by all blockholder types other than the Family/Management group is not significantly related to U.S. investment. Overall, the low disclosure subsample results are consistent with the argument that foreign outside investors adjust their quantity of investment significantly when information asymmetries are likely to most pronounced.

Panel B reports results for the high Disclosure Requirements subsample. We observe that none of the blockholder coefficients are negative and significant. We also report in the bottom row of Panel B the comparison between between the blockholder coefficients in the low and high protection subsamples. We find that all four of the managerial control coefficients are significantly more negative in the low protection subsample (p -values ≤ 0.01).¹⁷ These results confirm that the country-level disclosure environment has an important impact on how foreign investors perceive firm-level governance problems.

¹⁷ The significance level is based on (untabulated) combined regressions in which all variables are interacted with an indicator variable set equal to one when a country belongs to the low protection subsample.

In Tables 5 through 7, we split the sample based on three proxies for a country's overall level of investor protection. Higher protection reduces the private benefits of control and thus reduces the importance of information regarding these benefits. We expect that even if firms themselves have governance structures indicating potentially large private benefits of control, foreign investors will suffer less from information problems when investor protection is relatively high, and will therefore invest in greater quantities in these firms. On the flip side, we expect less foreign investment in firms likely to have high private benefits of control when external investor protection is relatively weak.

Table 5 features our Securities Regulation measure of shareholder protection. Panel A shows that the coefficients on our one nominal and three relative measures of Family/Management control are always negative and highly significant in the low protection subsample. The coefficients are similar in economic significance to those found in the low disclosure subsample reported in Table 4. The coefficients on other blockholdings are insignificant. In Panel B, which reports results for the high Securities Regulation subsample, we observe that none of the blockholder coefficients are negative and significant. In fact, several coefficients are significantly positive, but as our float-normalized dependent variable mechanically induces a positive bias, it is not appropriate to read much into this finding.¹⁸ Again, we find that the difference in the four effective managerial control coefficients between the low and high protection subsamples is always highly significant.

In Table 6, we split the sample based on non-English and English legal origin. As before, Panel A shows that the coefficients on all Family/Management control measures are always

¹⁸ Consistent with this claim, we show in subsequent robustness tests (Section 4.5) that scaling U.S. investment by total equity market capitalization, instead of float, results in insignificant coefficients for all ownership structure variables in countries with strong governance or securities regulation, but the coefficients on Family/Management control remain significantly negative in countries with weak institutions.

negative and highly significant in the non-English subsample and that the coefficients on other blockholdings are insignificant. Also, we find that the difference in the four effective managerial control coefficients between the non-English and English legal origin subsamples is always highly significant. In Table 7, we split the sample based on a country's Antidirector Rights and find that the coefficients on the effective managerial control measures are all negative and highly significant in the low shareholder protection subsample (Panel A), insignificant in the high protection subsample (Panel B), and the coefficient differences between the subsamples are highly significant.

4.4 Earnings Management and Foreign Investment

In this section, we attempt to shed some light on the mechanism by which poor governance manifests itself in lower holdings by U.S. investors. Towards this end, we analyze whether higher levels of earnings management are associated with lower levels of U.S. holdings. The basic idea is that earnings management is an indicator of opaque financial statements and poor information flows, created by poor corporate governance. Supporting this notion, Leuz, Nanda, and Wysocki (2003) and Ha, Hu, Hwang, and Wu (2004) show that poor country-level and firm-level governance is associated with higher levels of earnings management. Thus, if information problems are at the core of the holdings effect, we expect to find a negative association between earnings management and foreign holdings.¹⁹

To obtain firm-level proxies, we compute the earnings management variables from the time series of firms' earnings, accruals and cash flows from 1992 to 1997 and require that each

¹⁹ In a similar vein, Aggarwal, Klapper, and Wysocki (2005) show that investment in emerging market firms is positively associated with an aggregate accounting transparency measure. Across emerging and developed economies, Bradshaw, Bushee, and Miller (2004) show that U.S. investment is positively related to a firm's U.S. GAAP conformity.

firm has at least three years of relevant data. Cash flow from operations is calculated using the balance-sheet approach because U.S. style cash flow statements are generally not available for our sample companies.²⁰ If a firm does not report information on cash or short-term debt, then the changes in both variables are assumed to be zero. We scale earnings, accruals, and operating cash flows by lagged total assets prior to further computations to ensure comparability across firms and truncate extreme observations at the top and bottom percentile.

We consider two proxies. First, based on Haw, Hu, Hwang, and Wu (2004) and Wysocki (2004), we compute the time-series median magnitude of accruals relative to the cash flow from operations. Second, following Leuz et al. (2003), we compute three different proxies capturing a wide range of earnings management activities: i.e., the magnitude of total accruals, the smoothness of earnings relative to cash flows, and the correlation of accounting accruals and operating cash flows.²¹ Specifically, the first variable is the time-series median of the absolute value of accruals scaled by the contemporaneous operating cash flow. The second variable is computed as the time-series standard deviation of operating income over the time-series standard deviation of operating cash flows. The third variable is the time-series correlation of changes in the accruals and operating cash flows. The scores are averaged for each firm and are ranked such that higher values indicate more earnings management.

We recognize that these proxies are not perfect and indicate earnings management only in a relative sense. But in their defense, the more extreme the realizations of the measures become, the less likely it is that they reflect informative earnings, especially when considering that we compute them as medians of a large set of firms over several years. Moreover, the proxies are

²⁰ Following Dechow, Sloan, and Sweeney (1995), we compute the accrual component of earnings as $(\Delta \text{ total current assets} - \Delta \text{ cash}) - (\Delta \text{ total current liabilities} - \Delta \text{ short-term debt}) - \text{depreciation expense}$, where Δ denotes the change over the last fiscal year.

²¹ We do not compute a proxy for loss aversion as in Leuz, Nanda, and Wysocki (2003) because it cannot be reasonably computed at the firm level.

constructed relative to outcomes of firms' economic processes, such as the magnitude or smoothness of the operating cash flows, which makes it more likely that they capture firms' reporting choices to make earnings more or less informative. Finally, several recent studies suggest that these proxies yield country rankings that are consistent with widespread perceptions of earnings informativeness, and that the proxies behave in a plausible fashion around events such as U.S. cross listings (Lang, Raedy, and Yetman, 2003; Wysocki, 2004).

Table 8 reports results from Tobit regressions replacing the firm-level governance proxies with the two earnings management proxies. For the sake of brevity, we report only the findings splitting the sample by the level of securities regulation. The results are very similar using the other split variables (i.e., shareholder protection, disclosure requirements, and English legal origin) and are also present in the full sample of countries, albeit at a slightly weaker level (consistent with the results for the governance variables). Table 8 shows that both earnings management proxies are significantly and negatively associated with foreign holdings in the countries where securities regulation is weak. In contrast, the coefficients are insignificant in countries with strong securities regulation. As before, the combination of weak country-level institutions and poor firm-level governance is important for the holdings effect.

These findings suggest that U.S. investors hold fewer shares in firms with higher levels of earnings management, consistent with the hypothesis that information flows play an important role for foreigners' investment decisions. While these tests more directly focus on information flows than our tests using the governance proxies, it should be kept in mind that the quality of the information flows is in part driven by country-level institutions and firm-level governance. For this reason, we prefer to use the governance variables for our main analyses, which can be viewed as estimating a reduced form. The analyses in this section are primarily meant to shed

additional light on the mechanism by which poor governance manifests itself in fewer holdings by foreign investors.

4.5 Robustness Checks

In this section, we discuss several tests of robustness of our main firm-level governance regressions, which are not tabulated for sake of brevity. For instance, there is a clustering of observations in Japan and the U.K., creating the possibility that the results are dominated by one or two countries. For Japan, Lins and Servaes (1999) find that strong keiretsu membership is an indicator of governance problems, whereas ownership structure is not. Claessens, Djankov, Fan, and Lang (2002) exclude Japan from their analysis of ownership structure in East Asia because the keiretsu system influences governance in ways that cannot be captured by ownership data. The country dummies included in our analysis control for unique country parameters, but as a robustness check we re-estimate our firm-level regressions without Japan, the U.K., or both. In our study, removing Japan from the sample has virtually no effect on our main results. If we remove the U.K., our main results continue to hold – foreigners invest less in poorly governed firms that are in poor governance environments – but due to some wide confidence intervals in the strong-institution subsample regressions, differences in the coefficients between the strong- and weak-institution subsamples are in a few cases only marginally significant.

While we closely follow the literature on the determinants of foreign portfolio holdings when setting up our tests, it is possible that we have not modeled all of the variables that could affect foreign holdings. In particular, one might be concerned about the effects of liquidity and return momentum on the holdings of U.S. investors. Our tests include a firm's equity market capitalization and its book-to-market ratio which likely capture aspects of liquidity and return

momentum, respectively. But it is possible to construct some more direct measures for liquidity and momentum. As a robustness check, we re-estimate our models with the inclusion of these variables. Specifically, we follow Bekaert, Harvey, and Lundblad (2005) and Lesmond (2005) and proxy for liquidity with the percentage of trading days in the 1997 calendar year in which the stock had zero return for the day. We compute this measure only for firms with price data reported for at least 100 trading days in 1997. We compute a momentum variable defined as the 12 month buy-and-hold stock return over the period January 1, 1997 to December 31, 1997, winsorized at the 1st and 99th percent levels.

In Panel A of Table 9, we report the main results of the re-estimation of our base case models with the inclusion of liquidity and momentum variables. For the sake of brevity, we report only the coefficients on our two strongest measures of effective managerial control (managerial and family control rights percentage and an indicator variable corresponding to majority managerial and family control rights) and do so for only two of our country-level sample splits (Disclosure Requirements and Security Regulation). Despite a slightly smaller sample size, Panel A shows that the inclusion of liquidity and momentum control variable does not change our inferences. U.S. holdings are significantly lower when managers are likely to have effective control of their firms and the firms are domiciled in countries with poor disclosure and governance requirements.²²

Throughout this paper we have scaled U.S. investment by float, for the reasons described in Section 4.1. By making this choice, we mechanically bias against finding that any type of blockholding is negatively related to U.S. investment. On the other hand, scaling by market capitalization – even when controlling for float on the right hand side – likely biases the results

²² Results for the other effective managerial control variables and other splits by institutional variables are qualitatively similar.

in favor of finding that large blockholdings are related to lower foreign holdings. To illustrate this issue and gauge the robustness of our findings, we re-estimate our regressions scaling U.S. holdings by market capitalization (and controlling for float on the right-hand side). We do so for our base case models and for models which include liquidity and momentum control variables. For brevity, we again report only a partial set of coefficients.

Panel B of Table 9 shows that our results hold and even strengthen when we scale U.S. holdings by equity market capitalization and control for float on the right hand side. We find that the coefficients and t-statistics on our Family/Management control variables increase sharply in our low disclosure/protection subsamples relative to the float-normalized measure used thus far in the paper. While not tabulated, this outcome is true for the other managerial control variables and institutional country-level sample splits as well. Further, when scaling U.S. investment by market capitalization, we find that Other Blockholder control is never significant in any of the high or low subsample splits or overall and that Family/Management control is never positively related to U.S. holdings in high disclosure/protection subsamples. These findings show that scaling U.S. investment by float does not unduly affect our results and, if anything, biases against our hypothesis. Furthermore, the different results for Family/Management control and Other Blockholders illustrate that our findings are not simply a manifestation of ownership concentration.

Finally, Ammer, Holland, Smith and Warnock (2004) find that whether a foreign firm is cross-listed on a U.S. exchange is the single most important determinant of U.S. investment.²³ As such, we control for a U.S. listing in all models. However, as noted by Lang, Raedy, and Yetman (2003), cross listing is a firm choice that necessitates many substantive changes (which

²³ Indeed, an effort to enhance the shareholder base is often cited as an explanation for why non-U.S. firms undertake costly information-providing efforts such as listing on U.S. stock exchanges [Reese and Weisbach (2002) and Lins, Strickland, and Zenner (2005)].

often greatly improve information flow), suggesting that cross-listed firms may not be representative of a country's total population of publicly traded firms. To confirm that cross-listed firms are not unduly influencing our results, we re-estimate our regressions limiting the samples to non-cross-listed firms. Eliminating the 140 cross-listed firms has no effect on results for our full or emerging markets samples or for our sample splits by country-level institutional parameters. These untabulated robustness tests confirm that, net of cross-listing effects, poor firm-level governance is a deterrent to foreign investment when country-level disclosure and shareholder protection is weak.

5. Conclusion

This paper examines the relation between foreign investment and corporate governance. Foreign investors can play an important role in funding corporations, especially in countries in which domestic sources of outside finance are limited. However, institutional investors and regulators frequently claim that poor corporate governance is a substantial deterrent. As outside investors who fear governance problems can protect themselves by lowering the price they are willing to pay for a poorly governed firm's shares, it is not obvious that governance concerns will manifest themselves in fewer holdings. On the other hand, poorly governed firms from countries with weak institutions are likely to be particularly taxing on foreign investors in terms of their information and monitoring costs, which could explain why foreigners shy away from these firms.

We conduct tests on the relation between foreign investment and corporate governance for a sample of 4,411 firms from 29 countries. Using U.S. holdings as a proxy for foreign investment, we show that foreigners invest less in firms that are poorly governed. Specifically,

we find that firms with ownership structures that are more conducive to outside investor expropriation attract significantly less U.S. investment. We show that this finding is not simply a matter of a country's economic development but appears to be directly related to a country's legal institutions and information rules. Our paper is the first to provide compelling evidence for a large sample across many countries that foreigners do indeed invest less in poorly governed firms. We argue that information problems faced by foreign investors play an important role in this result. Supporting this explanation, we show that foreign investment in firms that appear to engage in more earnings management is lower in countries with poor information frameworks and legal institutions.

Our findings provide a sense that country-level improvements in disclosure and governance practices and firm-level improvements in governance or information flows are likely to attract more U.S. investment. To the extent that this attracts more total investment into a country, it implies that the home bias may be attenuated with such governance and information flow improvements. A test of changes in governance and information flows and changes in foreign investment choices across time may therefore be a potentially fruitful topic for future research.

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Table 1
Basic Summary Statistics by Country

U.S. Investment, obtained from AHSW, is the percent of the firm's float that was held by U.S. portfolio investors as of end-1997, where float is the percentage of shares not held by large blockholders (as given by Worldscope's Closely Held variable) multiplied by the market value of equity in billions of U.S. dollars. Size is the value of FY1997 total assets in millions of U.S. dollars. Ownership data list the median value of total direct and indirect control rights held by blockholder type. Family/Management (Mgmt) refers to total control rights held by family groups and the top management group. Other Blockholders (BH) refers to total control rights held by blockholders other than Family/Management. Ownership structure data are obtained from Claessens, Djankov, and Lang (2000), Faccio and Lang (2002), and Lins (2003). N is the number of firms that have data on ownership structure, end-1997 market capitalization from Datastream, and basic balance sheet variables from Worldscope. Numbers in parentheses indicate the smaller sample sizes for data on the frequency that Family/Mgmt control is greater than control by any other type of BH.

Country	N	U.S. Investment as a % of float (mean)	Size (Total assets in \$millions) (mean)	Family/Mgmt Control % (median)	Other BH Control % (median)	Frequency (%) that Family/Mgmt Control is:	
						Greater than any other BH	Greater than 50%
Argentina	6	54.0	4595	0	57	17	0
Austria	23	12.7	1429	38	0	52	43
Belgium	57	3.5	2275	45	0	72	42
Brazil	16	27.0	6408	0	22	25 (8)	13
Chile	39	11.7	1323	0	0	89 (19)	21
Czech Republic	6	13.9	169	0	5	67 (3)	17
Finland	60	9.9	913	23	0	58	25
France	359	7.5	2205	51	0	83	55
Germany	375	4.9	2383	56	0	82	60
Hong Kong	183	11.2	1035	42	0	80 (169)	40
Indonesia	19	10.5	217	0	7	64 (11)	32
Ireland	38	10.6	410	0	12	29	8
Israel	7	19.9	1647	50	0	71	57
Italy	53	9.0	4063	45	0	72	43
Japan	979	3.5	3012	0	10	14	0
Korea (South)	165	4.5	1996	14	5	75 (150)	1
Malaysia	250	4.6	586	30	16	71 (236)	18
Norway	90	9.4	799	25	0	61	16
Philippines	20	13.7	324	3	0	67 (9)	15
Portugal	32	11.2	744	49	0	84 (31)	50
Singapore	133	7.1	611	29	21	65 (126)	33
South Africa	102	8.0	775	7	9	57 (82)	41
Spain	63	8.4	2083	27	0	59	30
Sweden	136	9.2	1328	22	0	59	21
Switzerland	84	9.8	1390	50	0	73	50
Taiwan	9	1.8	659	0	0	100 (4)	0
Thailand	14	13.3	372	25	10	69 (13)	14
Turkey	16	32.8	211	19	48	44	38
UK	1077	5.7	1010	11	0	47	11
Total	4411	6.4	1754	13	5	52 (4284)	22
Europe	2469	6.9	1519	22	0	62 (2464)	30
Latin America	61	19.8	2978	0	0	61 (33)	16
Emerging Asia	800	7.1	975	25	7	73 (725)	23
Other	1081	3.9	2800	0	10	17 (1061)	4

Table 2
U.S. Investment and Blockholder Control – Full Sample of Countries

Tobit regression estimates of U.S. Investment scaled by float on blockholder control variables of interest and firm-level controls. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors' portfolio holdings as a share of float, where float is defined as the percentage of shares not held by large blockholders (as given by Worldscope's Closely Held variable) multiplied by the market value of equity in billions of U.S. dollars. XLIST and MSCI are indicator variables that take on the value one if the firm's equity is listed on a U.S. exchange or in the MSCI World Index, respectively. Ln(Size) is the log of total assets in millions of U.S. dollars. Leverage is the ratio of total liabilities to total assets. Book-to-market is book equity value over market equity value. Dividend yield is the preceding twelve months dividends paid over price. Financial variables are from Worldscope and are for fiscal year 1997. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses.

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.018 (0.021)					
Family/Mgmt control GT med		-0.099 (0.784)				
Family/Mgmt GT med & largest BH			-0.286 (0.435)			
Family/Mgmt control GT 50%				-0.829 (0.082)		
Other BH control percentage					0.005 (0.560)	
Other BH control GT 50%						0.357 (0.604)
XLIST	9.952 (0.000)	9.978 (0.000)	9.420 (0.000)	9.982 (0.000)	9.987 (0.000)	9.983 (0.000)
MSCI Membership	3.549 (0.000)	3.631 (0.000)	3.459 (0.000)	3.568 (0.000)	3.642 (0.000)	3.639 (0.000)
Ln(Size)	3.115 (0.000)	3.152 (0.000)	3.137 (0.000)	3.138 (0.000)	3.152 (0.000)	3.153 (0.000)
Leverage	-0.103 (0.000)	-0.104 (0.000)	-0.103 (0.000)	-0.103 (0.000)	-0.103 (0.000)	-0.103 (0.000)
Book-to-market	-1.021 (0.000)	-1.019 (0.000)	-1.061 (0.000)	-1.032 (0.000)	-1.016 (0.000)	-1.017 (0.000)
Dividend Yield	-0.105 (0.254)	-0.104 (0.261)	-0.092 (0.326)	-0.101 (0.272)	-0.106 (0.250)	-0.104 (0.256)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	4411	4411	4284	4411	4411	4411
Pseudo R ²	0.07	0.07	0.07	0.07	0.07	0.07

Table 3
U.S. Investment and Blockholder Control – Emerging Markets

Tobit regression estimates of U.S. Investment scaled by float on blockholder control variables of interest and firm-level controls in emerging markets. Emerging markets are defined based on classifications in the Economist magazine in December, 1997. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors' portfolio holdings as a share of float, where float is defined as the percentage of shares not held by large blockholders (as given by Worldscope's Closely Held variable) multiplied by the market value of equity in billions of U.S. dollars. XLIST and MSCI are indicator variables that take on the value one if the firm's equity is listed on a U.S. exchange or in the MSCI World Index, respectively. Ln(Size) is the log of total assets in millions of U.S. dollars. Leverage is the ratio of total liabilities to total assets. Book-to-market is book equity value over market equity value. Dividend yield is the preceding twelve months dividends paid over price. Financial variables are from Worldscope and are for fiscal year 1997. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses.

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	0.017 (0.917)					
Family/Mgmt control GT med		0.459 (0.558)				
Family/Mgmt GT med & largest BH			0.566 (0.496)			
Family/Mgmt control GT 50%				0.917 (0.343)		
Other BH control percentage					0.019 (0.298)	
Other BH control GT 50%						0.724 (0.546)
XLIST	11.75 (0.000)	11.79 (0.000)	7.828 (0.000)	11.86 (0.000)	11.49 (0.000)	11.66 (0.000)
MSCI Membership	8.185 (0.000)	8.190 (0.000)	8.441 (0.000)	8.271 (0.000)	8.145 (0.000)	8.166 (0.000)
Ln(Size)	3.786 (0.000)	3.795 (0.000)	3.749 (0.000)	3.783 (0.000)	3.732 (0.000)	3.766 (0.000)
Leverage	-0.138 (0.000)	-0.138 (0.000)	-0.138 (0.000)	-0.138 (0.000)	-0.135 (0.000)	-0.136 (0.000)
Book-to-market	-0.834 (0.016)	-0.834 (0.016)	-0.889 (0.017)	-0.816 (0.019)	-0.817 (0.018)	-0.829 (0.017)
Dividend Yield	0.180 (0.282)	0.180 (0.281)	0.267 (0.131)	0.176 (0.292)	0.168 (0.315)	0.173 (0.300)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	1017	1017	890	1017	1017	1017
Pseudo R ²	0.08	0.08	0.09	0.08	0.08	0.08

Table 4
U.S. Investment, Blockholder Control, and Disclosure Requirements

Tobit regression estimates of U.S. Investment scaled by float on blockholder control variables of interest and controls estimated on subsamples of countries with low and high disclosure requirements. “Disclosure Requirement” values potentially range from 0 to 1 and are obtained from Table 2 of La Porta, Lopez-de-Silanes, and Shleifer (2004). The “High Disclosure Requirements” subsample contains countries that score above our sample median of 0.75 on the Disclosure Requirement measure. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors’ portfolio holdings as a share of float, where float is defined as the percentage of shares not held by large blockholders (as given by Worldscope’s Closely Held variable) multiplied by the market value of equity in billions of U.S. dollars. Other model variables are described previously in Table 2. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses. At the bottom of Panel B, we report the p-value of the difference in coefficients on the blockholder variable of interest in the low and high disclosure requirement subsamples.

Panel A: Low Disclosure Requirements

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.041 (0.000)					
Family/Mgmt control GT med		-1.046 (0.025)				
Family/Mgmt GT med & largest BH			-1.201 (0.013)			
Family/Mgmt control GT 50%				-2.295 (0.000)		
Other BH control percentage					-0.012 (0.355)	
Other BH control GT 50%						-0.470 (0.606)
XLIST	9.948 (0.000)	10.094 (0.000)	8.952 (0.000)	10.031 (0.000)	10.095 (0.000)	10.104 (0.000)
MSCI Membership	2.111 (0.001)	2.236 (0.000)	2.223 (0.000)	2.161 (0.001)	2.246 (0.000)	2.264 (0.000)
Ln(Size)	3.134 (0.000)	3.187 (0.000)	3.179 (0.000)	3.169 (0.000)	3.263 (0.000)	3.254 (0.000)
Leverage	-0.132 (0.000)	-0.133 (0.000)	-0.134 (0.000)	-0.132 (0.000)	-0.134 (0.000)	-0.134 (0.000)
Book-to-market	-0.852 (0.006)	-0.845 (0.006)	-0.668 (0.037)	-0.866 (0.005)	-0.848 (0.006)	-0.843 (0.006)
Dividend Yield	-0.164 (0.219)	-0.164 (0.217)	-0.117 (0.390)	-0.157 (0.238)	-0.172 (0.196)	-0.174 (0.191)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	2626	2626	2569	2626	2626	2626
Pseudo R ²	0.08	0.08	0.08	0.08	0.08	0.08

Panel B: High Disclosure Requirements

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	0.006 (0.601)					
Family/Mgmt control GT med		0.814 (0.142)				
Family/Mgmt GT med & largest BH			0.647 (0.250)			
Family/Mgmt control GT 50%				0.9050 (0.226)		
Other BH control percentage					0.024 (0.094)	
Other BH control GT 50%						1.237 (0.238)
XLIST	9.443 (0.000)	9.511 (0.000)	9.569 (0.000)	9.422 (0.000)	9.464 (0.000)	9.446 (0.000)
MSCI Membership	6.169 (0.000)	6.162 (0.000)	5.892 (0.000)	6.252 (0.000)	6.095 (0.000)	6.094 (0.000)
Ln(Size)	2.935 (0.000)	2.960 (0.000)	2.921 (0.000)	2.930 (0.000)	2.932 (0.000)	2.930 (0.000)
Leverage	-0.049 (0.005)	-0.050 (0.004)	-0.045 (0.010)	-0.049 (0.005)	-0.047 (0.007)	-0.047 (0.007)
Book-to-market	-1.269 (0.001)	-1.276 (0.000)	-1.638 (0.000)	-1.247 (0.001)	-1.263 (0.001)	-1.266 (0.001)
Dividend Yield	-0.105 (0.420)	-0.098 (0.451)	-0.087 (0.511)	-0.106 (0.414)	-0.047 (0.007)	-0.119 (0.361)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	1779	1779	1712	1779	1779	1779
Pseudo R ²	0.05	0.05	0.05	0.05	0.05	0.05
P-value on blockholder coefficient difference between subsamples	0.002	0.008	0.010	0.001	0.331	0.224

Table 5
U.S. Investment, Blockholder Control, and Securities Regulation

Tobit regression estimates of U.S. Investment scaled by float estimated on subsamples of countries with low and high scores on securities regulation. “Securities Regulation” values potentially range from 0 to 1 and are defined as in Hail and Leuz (2004) as the average of the Disclosure Requirements, Liability Standards, and Public Enforcement indexes, which are obtained from Table 2 of La Porta, Lopez-de-Silanes, and Shleifer (2004). The “High Securities Regulation” subsample contains countries that score above our sample median of 0.58 on the Securities Regulation measure. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors’ portfolio holdings as a share of float, where float is as defined in Table 2. Other model variables are described previously in Table 2. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses. At the bottom of Panel B, we report the p-value of the difference in coefficients on the blockholder variable of interest in the low and high Securities Regulation subsamples.

Panel A: Low Securities Regulation

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.044 (0.000)					
Family/Mgmt control GT med		-1.277 (0.005)				
Family/Mgmt GT med & largest BH			-1.450 (0.002)			
Family/Mgmt control GT 50%				-2.454 (0.000)		
Other BH control percentage					-0.001 (0.962)	
Other BH control GT 50%						0.117 (0.893)
XLIST	9.463 (0.000)	9.644 (0.000)	8.464 (0.000)	9.565 (0.000)	9.660 (0.000)	9.659 (0.000)
MSCI Membership	2.408 (0.000)	2.549 (0.000)	2.614 (0.000)	2.471 (0.000)	2.605 (0.000)	2.610 (0.000)
Ln(Size)	3.118 (0.000)	3.163 (0.000)	3.145 (0.000)	3.153 (0.000)	3.231 (0.000)	3.228 (0.000)
Leverage	-0.132 (0.000)	-0.134 (0.000)	-0.135 (0.000)	-0.132 (0.000)	-0.134 (0.000)	-0.134 (0.000)
Book-to-market	-0.661 (0.027)	-0.650 (0.030)	-0.494 (0.117)	-0.671 (0.025)	-0.634 (0.035)	-0.634 (0.035)
Dividend Yield	-0.144 (0.267)	-0.149 (0.250)	-0.125 (0.346)	-0.138 (0.287)	-0.163 (0.210)	-0.163 (0.210)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	2693	2693	2629	2693	2693	2693
Pseudo R ²	0.08	0.08	0.08	0.08	0.08	0.08

Panel B: High Securities Regulation

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	0.016 (0.211)					
Family/Mgmt control GT med		1.256 (0.027)				
Family/Mgmt GT med & largest BH			1.063 (0.064)			
Family/Mgmt control GT 50%				1.397 (0.072)		
Other BH control percentage					0.012 (0.395)	
Other BH control GT 50%						0.553 (0.620)
XLIST	10.073 (0.000)	10.194 (0.000)	10.287 (0.000)	10.038 (0.000)	10.136 (0.000)	10.104 (0.000)
MSCI Membership	5.822 (0.000)	5.774 (0.000)	5.279 (0.000)	5.917 (0.000)	5.706 (0.000)	5.699 (0.000)
Ln(Size)	2.967 (0.000)	2.998 (0.000)	2.976 (0.000)	2.948 (0.000)	2.944 (0.000)	2.942 (0.000)
Leverage	-0.048 (0.006)	-0.049 (0.005)	-0.043 (0.015)	-0.047 (0.007)	-0.047 (0.008)	-0.047 (0.008)
Book-to-market	-1.606 (0.000)	-1.627 (0.000)	-1.935 (0.000)	-1.572 (0.000)	-1.592 (0.000)	-1.593 (0.000)
Dividend Yield	-0.080 (0.550)	-0.071 (0.597)	-0.061 (0.651)	-0.082 (0.537)	-0.101 (0.450)	-0.095 (0.480)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	1712	1712	1652	1712	1712	1712
Pseudo R ²	0.05	0.05	0.06	0.05	0.05	0.05
P-value on blockholder coefficient difference between subsamples	0.000	0.000	0.001	0.000	0.703	0.650

Table 6
U.S. Investment, Blockholder Control, and Legal Origin

Tobit regression estimates of U.S. Investment scaled by float on blockholder control variables of interest and controls estimated on subsamples of countries without and with an English Common Law legal origin as indicated in Table 2 of LLSV (1998). U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors' portfolio holdings as a share of float, where float is defined as the percentage of shares not held by large blockholders (as given by Worldscope's Closely Held variable) multiplied by the market value of equity in billions of U.S. dollars. Other model variables are described previously in Table 2. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses. At the bottom of Panel B, we report the p-value of the difference in coefficients on the blockholder variable of interest in the non-English and English legal origin subsamples.

Panel A: Not English Common Law

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.040 (0.000)					
Family/Mgmt control GT med		-1.107 (0.022)				
Family/Mgmt GT med & largest BH			-1.300 (0.006)			
Family/Mgmt control GT 50%				-2.376 (0.000)		
Other BH control percentage					-0.006 (0.642)	
Other BH control GT 50%						-0.186 (0.839)
XLIST	8.558 (0.000)	8.730 (0.000)	7.509 (0.000)	8.656 (0.000)	8.756 (0.000)	8.757 (0.000)
MSCI Membership	2.760 (0.000)	2.873 (0.000)	2.615 (0.000)	2.806 (0.000)	2.900 (0.000)	2.911 (0.000)
Ln(Size)	3.096 (0.000)	3.145 (0.000)	3.125 (0.000)	3.125 (0.000)	3.211 (0.000)	3.206 (0.000)
Leverage	-0.132 (0.000)	-0.133 (0.000)	-0.130 (0.000)	-0.131 (0.000)	-0.133 (0.000)	-0.133 (0.000)
Book-to-market	-0.630 (0.036)	-0.622 (0.039)	-0.624 (0.046)	-0.644 (0.032)	-0.622 (0.039)	-0.619 (0.040)
Dividend Yield	-0.131 (0.321)	-0.136 (0.302)	-0.046 (0.731)	-0.126 (0.338)	-0.148 (0.262)	-0.148 (0.260)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	2607	2607	2536	2607	2607	2607
Pseudo R ²	0.08	0.08	0.08	0.08	0.08	0.08

Panel B: English Common Law

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	0.009 (0.457)					
Family/Mgmt control GT med		0.905 (0.103)				
Family/Mgmt GT med & largest BH			0.710 (0.212)			
Family/Mgmt control GT 50%				1.085 (0.147)		
Other BH control percentage					0.018 (0.203)	
Other BH control GT 50%						0.908 (0.385)
XLIST	10.866 (0.000)	10.931 (0.000)	10.895 (0.000)	10.842 (0.000)	10.912 (0.000)	10.893 (0.000)
MSCI Membership	5.118 (0.000)	5.091 (0.000)	5.157 (0.000)	5.210 (0.000)	5.032 (0.000)	5.037 (0.000)
Ln(Size)	3.012 (0.000)	3.038 (0.000)	3.019 (0.000)	3.003 (0.000)	3.000 (0.000)	2.999 (0.000)
Leverage	-0.051 (0.003)	-0.053 (0.003)	-0.055 (0.002)	-0.051 (0.004)	-0.050 (0.004)	-0.050 (0.004)
Book-to-market	-1.626 (0.000)	-1.635 (0.000)	-1.740 (0.000)	-1.599 (0.000)	-1.623 (0.000)	-1.623 (0.000)
Dividend Yield	-0.065 (0.620)	-0.057 (0.661)	-0.100 (0.455)	-0.067 (0.607)	-0.086 (0.514)	-0.0787 (0.554)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	1804	1804	1748	1804	1804	1804
Pseudo R ²	0.05	0.05	0.05	0.05	0.05	0.05
P-value on blockholder coefficient difference between subsamples	0.001	0.004	0.004	0.000	0.560	0.465

Table 7
U.S. Investment, Blockholder Control, and Antidirector Rights

Tobit regression estimates of U.S. Investment scaled by float estimated on subsamples of countries with low and high shareholder rights as measured by Antidirector Rights. “Antidirector Rights” values range from 0 to 5 and are obtained from Table 2 of LLSV (1998). The “Low Antidirector Rights” subsample contains countries that score below 4 on the Antidirector Rights measure. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors’ portfolio holdings as a share of float, where float is as defined in Table 2. Other model variables are described previously in Table 2. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses. At the bottom of Panel B, we report the p-value of the difference in coefficients on the blockholder variable of interest in the low and high Antidirector Rights subsamples.

Panel A: Low Antidirector Rights

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.040 (0.004)					
Family/Mgmt control GT med		-1.466 (0.047)				
Family/Mgmt GT med & largest BH			-1.613 (0.030)			
Family/Mgmt control GT 50%				-2.326 (0.005)		
Other BH control percentage					-0.031 (0.094)	
Other BH control GT 50%						-1.202 (0.368)
XLIST	6.487 (0.002)	6.588 (0.002)	7.176 (0.001)	6.610 (0.002)	6.647 (0.002)	6.677 (0.002)
MSCI membership	3.198 (0.003)	3.399 (0.001)	2.957 (0.006)	3.249 (0.002)	3.499 (0.001)	3.530 (0.001)
Ln(Size)	3.814 (0.000)	3.872 (0.000)	3.827 (0.000)	3.848 (0.000)	4.025 (0.000)	3.978 (0.000)
Leverage	-0.133 (0.000)	-0.135 (0.000)	-0.129 (0.000)	-0.134 (0.000)	-0.137 (0.000)	-0.136 (0.000)
Book-to-market	-0.301 (0.499)	-0.299 (0.501)	-0.403 (0.394)	-0.316 (0.477)	-0.327 (0.462)	-0.308 (0.489)
Dividend Yield	-0.245 (0.189)	-0.246 (0.189)	-0.166 (0.394)	-0.246 (0.187)	-0.266 (0.155)	-0.266 (0.155)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	1445	1445	1396	1445	1445	1445
Pseudo R ²	0.07	0.07	0.07	0.07	0.07	0.07

Panel B: High Antidirector Rights

	(1)	(2)	(3)	(4)	(5)	(6)
Family/Mgmt control percentage	-0.002 (0.802)					
Family/Mgmt control GT med		0.558 (0.163)				
Family/Mgmt GT med & largest BH			0.428 (0.303)			
Family/Mgmt control GT 50%				0.405 (0.503)		
Other BH control percentage					0.023 (0.034)	
Other BH control GT 50%						1.134 (0.156)
XLIST	11.508 (0.000)	11.526 (0.000)	10.538 (0.000)	11.513 (0.000)	11.507 (0.000)	11.500 (0.000)
MSCI Membership	3.577 (0.000)	3.589 (0.000)	3.641 (0.000)	3.612 (0.000)	3.597 (0.000)	3.585 (0.000)
Ln(Size)	2.690 (0.000)	2.719 (0.000)	2.724 (0.000)	2.695 (0.000)	2.694 (0.000)	2.688 (0.000)
Leverage	-0.088 (0.000)	-0.088 (0.000)	-0.091 (0.000)	-0.088 (0.000)	-0.087 (0.000)	-0.087 (0.000)
Book-to-market	-1.577 (0.000)	-1.581 (0.000)	-1.560 (0.000)	-1.569 (0.000)	-1.564 (0.000)	-1.568 (0.000)
Dividend Yield	-0.030 (0.773)	-0.022 (0.829)	-0.038 (0.723)	-0.028 (0.786)	-0.050 (0.632)	-0.038 (0.716)
Industry Controls?	Yes	Yes	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes	Yes	Yes
N	2960	2960	2885	2960	2960	2960
Pseudo R ²	0.06	0.06	0.06	0.06	0.06	0.06
P-value on blockholder coefficient difference between subsamples	0.031	0.016	0.017	0.009	0.194	0.126

Table 8
U.S. Investment, Earnings Management, and Securities Regulation

Tobit regression estimates of U.S. Investment scaled by float estimated on subsamples of countries with low and high scores on securities regulation. “Securities Regulation” values potentially range from 0 to 1 and are defined as in Hail and Leuz (2004) as the average of the Disclosure Requirements, Liability Standards, and Public Enforcement indexes, which are obtained from Table 2 of La Porta, Lopez-de-Silanes, and Shleifer (2004). The “High Securities Regulation” subsample contains countries that score above our sample median of 0.58 on the Securities Regulation measure. U.S. Investment is as of end-1997 and is defined the dollar value of U.S. investors’ portfolio holdings as a share of float, where float is as defined in Table 2. The first proxy for earnings management (EM) is based on Haw et al. (2004) and Wysocki (2004) and computed as the median magnitude of accruals relative to the cash flow from operations. The second proxy is an aggregate earnings management score based on Leuz et al. (2003). For the aggregate EM proxy, we compute three scores: (1) the magnitude of accruals relative to the operating cash flow, (2) the standard deviation of operating earnings over the standard deviation of operating cash flows, and (3) the correlation of changes in accruals and changes in operating cash flows. All variables are computed by firm from 1992 to 1997. The scores are averaged for each firm and are ranked such that higher values indicate more earnings management. Other model variables are described previously in Table 2. Indicator variables for countries and industry groups (based on the classification of Campbell, 1996) are included but not reported. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses. At the bottom of the table, we report the p-value of the difference in coefficients on the earnings management variable of interest in the low and high Securities Regulation subsamples.

	<i>Panel A:</i> <i>Low Securities Regulation</i>		<i>Panel B:</i> <i>High Securities Regulation</i>	
	(1)	(2)	(3)	(4)
Magnitude of Accruals	-3.517 (0.000)		0.3577 (0.733)	
Aggregate EM Score		-0.0013 (0.001)		0.0000 (0.980)
XLIST	8.480 (0.000)	8.359 (0.000)	6.111 (0.007)	7.494 (0.001)
MSCI Membership	2.449 (0.010)	1.599 (0.107)	5.520 (0.000)	5.548 (0.000)
Ln(Size)	3.634 (0.000)	3.876 (0.000)	2.960 (0.000)	2.845 (0.000)
Leverage	-0.131 (0.000)	-0.141 (0.000)	-0.018 (0.553)	-0.011 (0.723)
Book-to-market	0.036 (0.955)	-0.023 (0.973)	-2.835 (0.000)	-2.783 (0.000)
Dividend Yield	-0.380 (0.088)	-0.187 (0.417)	0.152 (0.501)	0.159 (0.484)
Industry Controls?	Yes	Yes	Yes	Yes
Country Controls?	Yes	Yes	Yes	Yes
N	1204	1115	786	732
Pseudo R ²	0.09	0.09	0.07	0.07
P-value on EM coefficient difference between low and high subsamples			0.004	0.037

Table 9
Robustness Tests

The table reports coefficients on Family/Mgmt (F/M) control percentage and on an indicator variable for Family/Mgmt control percentage greater than 50% for a series of regression models that contain all control variables found in the base case models estimated in Tables 2 through 7, and feature one or more additional variables for robustness. Liquidity refers to the percentage of trading days in the 1997 calendar year in which the stock had zero return for the day – this measure is computed only for firms with price data reported for at least 100 trading days in 1997. Momentum refers to the 12 month buy-and-hold stock return over the period January 1, 1997 to December 31, 1997, winsorized at the 1st and 99th percent levels. In Panel A, the dependent variable is U.S. Investment scaled by float, consistent with all prior reported regressions. In Panel B, the dependent variable is U.S. Investment scaled by total market capitalization, and float in U.S. dollars is included as an additional right hand side variable. The models are separately estimated for subsamples of countries with low and high scores on Disclosure Requirements and on Securities Regulation as described in Tables 4 and 5. For each coefficient, the p-value of the two-tailed t-test of equality with zero is reported in parentheses.

Panel A: Dependent variable is U.S. Investment as a percentage of float

	<i>Low Disclosure Requirements</i>		<i>Low Securities Regulation</i>		<i>High Disclosure Requirements</i>		<i>High Securities Regulation</i>	
	F/M control	F/M control > 50%	F/M control	F/M control > 50%	F/M control	F/M control > 50%	F/M control	F/M control > 50%
Includes liquidity and momentum variables	-0.025 (0.018)	-1.835 (0.004)	-0.027 (0.006)	-1.941 (0.002)	0.011 (0.381)	1.132 (0.139)	0.018 (0.158)	1.523 (0.056)
Number of observations	2465	2465	2526	2526	1655	1655	1594	1594

Panel B: Dependent variable is U.S. Investment as a percentage of equity market capitalization

	<i>Low Disclosure Requirements</i>		<i>Low Securities Regulation</i>		<i>High Disclosure Requirements</i>		<i>High Securities Regulation</i>	
	F/M control	F/M control > 50%	F/M control	F/M control > 50%	F/M control	F/M control > 50%	F/M control	F/M control > 50%
Base case model	-0.030 (0.000)	-1.856 (0.000)	-0.032 (0.000)	-1.900 (0.000)	-0.005 (0.430)	-0.093 (0.825)	-0.001 (0.858)	0.119 (0.784)
Number of observations	2625	2625	2691	2691	1778	1778	1712	1712
Includes liquidity and momentum variables	-0.026 (0.000)	-1.713 (0.000)	-0.027 (0.000)	-1.723 (0.000)	-0.002 (0.730)	0.065 (0.881)	0.001 (0.936)	0.212 (0.633)
Number of observations	2465	2465	2526	2526	1655	1655	1594	1594

