Professor Andrew Karolyi and the *Morrison* Decision: Measuring the Value of U.S. Securities Law to Investors

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Professor Andrew Karolyi, Faculty Co-Director of Johnson's Emerging Markets Institute, says a June 2010 decision by the United States Supreme Court has driven a major wedge between U.S. and foreign securities markets, increasing costs to U.S. investors seeking foreign exposure and impeding the flow of U.S. capital abroad.

Karolyi has been studying the aftershocks of *Morrison v. National Australia Bank*, in which the Court held that only securities purchased on U.S. exchanges or on U.S. soil (if traded over the counter) are subject to the fraud protection provisions of Section 10(b) of the Securities Act.

"The Supreme Court's ruling upended decades of legal precedent," Karolyi explains. "Before the decision, investors always had recourse in the U.S. courts if a fraud affected U.S. markets. *Morrison* sharply restricted investors' rights. Suddenly, a wide range of routine investment transactions no longer fell under the umbrella of U.S. securities laws."

The decision left many investors in foreign securities at sea. And Karolyi believes that what investors buying offshore had lost—the protection of U.S. law—was quite valuable.

"Overnight, foreign stocks purchased outside the United States, even if cross-listed on U.S. exchanges, lost the value premium they had gained by their association with U.S. legal and regulatory institutions," he explains.

This phenomenon, commonly called the "bonding effect," already had been the subject of an extensive body of research undertaken by Karolyi and his colleagues.

Measuring the Impact

Karolyi and his primary collaborator Louis Gagnon, of Queen's University School of Business, decided to apply the techniques of their previous research to the task of measuring the new legal regime's added cost to investors. They previously had shown that the prices of foreign securities and those of their corresponding American Depositary Receipts (ADRs), through which they were cross-listed on U.S. exchanges, generally tracked quite closely with each other—within a few basis points (hundredths of a percent). Any small price premiums commanded by ADRs were easily accounted for by administrative costs and other factors that might impede arbitrage across markets. Karolyi and Gagnon assembled a sample of 1,000 cross-listed firms in 42 countries, and looked at prices before and after the decision.

What they found, in a November 2011 study , was startling. On the day of the Supreme Court decision, home market share prices and ADRs diverged by an average of 37 basis points. In

other words, ADRs for foreign shares suddenly became about one-third of a percentage point more valuable than the underlying foreign shares. They judged that the economic consequences of this divergence across all affected securities exceeded billions of dollars. Karolyi and Gagnon believe that the higher valuation of ADRs reflects many investors' willingness to pay more to retain U.S. fraud coverage for foreign investments.

"This new additional cost to investors of American legal coverage is quite significant," Karolyi points out. "It is a substantial disincentive to foreign investment."

Who Bears the Cost…and How

Karolyi believes that the sectors most affected by the new cost and extra burdens of cross-border investment are U.S. institutional investors and small-to-medium-sized firms in emerging markets. Institutional investors, facing higher costs or additional constraints, may reduce their international diversification, and emerging-market companies that already find cross-listing on U.S. exchanges prohibitively expensive will have an even harder time attracting capital from the United States.

"U.S. investors seeking shares in companies that are lightly traded in American markets may well be dissuaded from doing what has been normal course of business until now: seeking out the shares where they are available in quantity, which is typically in their home markets," he says.

The authors found that the *Morrison* decision has also substantially disrupted existing investment practices, and created many areas of legal uncertainty. A natural consequence of the previous functional equivalence of ADRs and foreign shares is that the actual market on which shares were acquired was never viewed as significant. Indeed, investors who place an order for a foreign security usually do not know where it will be purchased, nor do they typically have control over where the transaction occurs. Brokers generally execute orders in whatever market is the most convenient and liquid, with liquidity being particularly important for large share transactions.

"One particularly thorny problem created by *Morrison* is that there are no systems or regulations in place to ensure that securities transactions happen only in markets specified by investors," Karolyi explains. "Investors have no easy way of ensuring that they will be covered by U.S. law when they purchase foreign securities. That's a major problem."

The ruling also created very significant issues with regard to derivative investments. Domestically-traded derivatives based on foreign securities might well be covered by the new legal regime, whereas foreign-traded derivatives based on domestic securities might not be. The confusion is likely to persist until additional litigation clarifies the consequences of the 2010 decision—or until Congress acts.

The *Morrison* Decision, Legislative Action, and the SEC

The Supreme Court released its decision less than a month before final passage of the Dodd-Frank financial system reform bill, and, at the urging of institutional investors and many others, some provisions addressing the decision were added to the bill. Congress restored the ability of the Securities and Exchange Commission (SEC) to bring enforcement actions under the old standard for fraud involving foreign securities. For private lawsuits, however, Congress left the new standard in place, while directing the SEC to study the issue and report back within 18 months.

The SEC released its report in April 2012. The study did not recommend a course of action to Congress, instead enumerating a range of policy choices. The report did cite and discuss Karolyi and Gagnon's study, along with its own research and another academic study, but did not endorse any conclusions. The SEC commissioners merely forwarded the staff study to Congress, without a policy recommendation, though one member—Commissioner Luis A. Aguilar, a former securities lawyer originally appointed by President George W. Bush, issued a blistering "dissenting statement" advocating a complete restoration of the law as it stood before *Morrison*. Aguilar argued that the decision represents a major loss to American investors, and that private lawsuits are an essential complement to SEC enforcement, which is inherently limited by virtue of staff and budget constraints.

All of this is setting the stage for a confrontation in Congress, most likely after the 2012 election. For Professor Karolyi, the *Morrison* decision has been of twofold interest. First, it offered up a fascinating and unexpected natural experiment for the bonding hypothesis: a quick before-and-after study of bonded vs. unbonded securities. Second, it is a major economic issue that has effectively put sand in the gears of international investment. He believes that further study is essential on both fronts.

Going forward, Karolyi and his collaborators plan to try to widen their lens of inquiry, examining whether the price gap between ADRs and home-market securities has persisted, and whether it is volatile. They also would like to more accurately quantify the impact of the decision, in terms of lost market capitalization for affected firms. Whatever the results, Professor Karolyi is likely to be on the shortlist of witnesses as Congress debates how U.S. law should treat foreign securities transactions.