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The liability of foreignness in capital markets: Sources and remedies

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The liability of foreignness in capital markets: Sources and remedies

Abstract

The accelerating pace of global capital market integration has provided new opportunities for firms to raise capital abroad through global debt issues, cross-listings and initial public offerings in foreign stock exchanges. However, existing empirical evidence suggests that foreign firms tend to be at a disadvantage compared to domestic firms, and they often suffer from investors' "home bias". The objective of this paper is to understand why firms are facing problems when accessing capital in foreign markets, and possible mechanism that can help to mitigate these problems. It expands the Liability of Foreignness (LOF) research beyond the product market domain to include liabilities faced by firms attempting to secure resources in foreign capital markets. We identify key differences between product and capital markets related to information environment, time structure of transactions, and linkages between buyers and sellers. We analyze institutional distance, information asymmetry, unfamiliarity, and cultural differences as the main sources of capital market LOF (CMLOF). We suggest possible mechanisms managers can employ to mitigate CMLOF and overcome investors' "home bias", including bonding, signaling, organizational isomorphism, and reputational endorsements. We also outline directions for further theoretical and empirical development of the CMLOF research.

Key Words: Liability of Foreignness, Institutional theory, Institutional Context, Capital Markets

INTRODUCTION

The accelerating pace of global capital market integration in the last two decades has had a profound impact on the strategies of firms accessing capital resources. Today, with the lowering of institutional barriers, cross-border equity capital flows occur in a variety of ways such as foreign portfolio investment, cross-listings, and initial public offerings in foreign stock exchanges. Similarly, firms are increasingly looking outside of their home markets for debt finance and for Venture Capital (VC) resources (Gozzi, Levine, & Schmukler, 2010; Makela & Maula, 2008). However, recent international finance studies suggest that foreign firms tend to be at a disadvantage in that they are likely to experience higher cost of capital, lower liquidity, and less analyst coverage (Blass & Yafeh, 2001) than the local firms against whom they compete for resources in host capital markets. Further, a number of foreign firms have been found to withdraw shortly after entering host capital markets. Extant literature, however, provides only limited theoretical understanding about the underlying factors that cause foreign firms to experience higher costs associated with being foreign in host capital markets. This, in turn, has resulted in limited ability to identify potential remedies foreign firms can deploy to mitigate these costs. Therefore, the objective of this paper is to understand why firms are facing problems when accessing capital in foreign markets. By doing this, we expand the domain of the liabilities of foreignness (LOF) research to the context of liabilities faced by firms accessing host country capital markets[i]. Throughout the rest of this paper, we refer to these liabilities as capital market liabilities of foreignness, or CMLOF. Our focus is on the sources of CMLOF and potential remedies firms approaching foreign capital markets can deploy to reduce these liabilities.

The conceptualization and analysis of LOF in international business (IB) research were essentially developed in the context of firms expanding their products, services, and operations to other countries. To date, a significant body of theoretical and empirical research has accumulated evaluating the sources of LOF that foreign firms face in host countries, compared to local firms (Caves, 1971; Hymer, 1976). IB scholars consider LOF as the "fundamental assumption driving theories of the

multinational enterprise" (Zaheer, 1995: 341), and an understanding of LOF is usually associated with issues such as the local lack of knowledge of the foreign firm's products and brand, and cultural differences in management practices that ultimately lead to foreign firms competing at a disadvantage and underperforming against local competitors in host markets. While this may have been adequate in an era when internationalization was understood almost exclusively as globalization of product markets, the increasing integration of capital markets adds a new dimension to internationalization where a firm, in addition to selling its product and services to foreign customers, may also attempt to raise equity, debt, or VC resources from foreign investors. A number of studies in IB and finance demonstrate that investors in both developed and developing markets strongly prefer to invest in local firms rather than foreign firms in capital markets (Ke, Ng, & Wang, 2010). This "home bias" puzzle, first documented by French and Poterba (1991) and Tesar and Werner (1995), is one of the major research questions in international finance, but there is a paucity of studies that provide a comprehensive analysis of factors contributing to this phenomenon, as well as possible remedies firms may use to overcome home bias when raising finance globally.

This paper makes a number of contributions to both IB and international finance research. First, we show how LOF framework may be usefully deployed within international finance research, and we provide arguments that justify a specific focus on capital markets as opposed to markets for products and services. These markets differ significantly in terms of information environment, time structure of transactions, and linkages between buyers and sellers, which suggests that the nature and sources of LOF in the two markets may be different. Buyers in capital markets expect to obtain long-term rents, and they may be particularly sensitive to both short-term (e.g., adverse selection) and long-term (e.g., moral hazard) agency costs associated with a seller. As a result, liabilities of foreignness associated with selling financial securities abroad may be less transaction-specific and depend on the long-term buyers' expectations with regard to an issuer. Although research in IB has long recognized that firms face LOF when competing abroad, both international business and finance researchers do not provide a comprehensive theoretical explanation as to how the disadvantages that firms face in foreign capital

markets in comparison to local firms may be different or similar to disadvantages in product markets. The major theoretical contribution of our paper lies in addressing this previously neglected, but increasingly important issue.

Our second contribution is related to the analysis of root causes of CMLOF, which extends traditional LOF research and international finance studies by integrating them with institutional theory. We develop a framework that includes the costs facing firms in host country capital markets and the willingness of host market investors to devote resources to outside firms. We classify these costs as arising out of institutional distance, difficulties in information gathering, unfamiliarity, and cultural distance, and argue that these factors may be particularly important sources of the CMLOF. More specifically, we explain how CMLOF costs may be driven by underlying institutional differences between home and host markets. Similarly, information flows are an important determinant of cross-border capital transactions (Portes & Rey, 2005). Likewise, unfamiliarity amongst potential investors is likely to impact international equity, debt, and VC transactions. Finally, it is quite plausible that cultural differences between countries will influence a wide range of capital market transactions (Guiso, Sapienza, & Zingales, 2009) and ultimately impact the performance of foreign firms in host capital markets relative to local competitors. Previous IB research on LOF in product markets provides useful guidance in terms of potential effects of some of these factors. However, it does not offer a comprehensive theoretical framework analyzing how liability of foreignness in capital markets affects financing decisions which would be highly relevant to both IB and international finance studies.

Finally, if there are indeed fundamental differences in the sources of LOF between product and capital markets, then researchers need to re-think possible solutions foreign firms may deploy to minimize these liabilities. Although international finance research has identified several specific liabilities that firms encounter when seeking resources in foreign capital markets, it is yet to develop a comprehensive analysis of measures foreign issuers can deploy to minimize these liabilities. Navigating the dynamic international capital market environment and attracting capital market resource providers located in dissimilar cultural and institutional environments is a difficult challenge facing the international manager.

Just as managers must contend with liabilities of foreignness in product markets, they must also be aware of the sources of CMLOF and be prepared to mitigate the resulting costs. If liabilities of foreignness are prevalent in the capital markets, it has implications for a firm's cost of capital and firm value (Stulz, 1999). Therefore, we make a further contribution by focusing on issues related to organizational legitimacy and identify a number of possible mechanisms managers can employ to mitigate CMLOF and overcome "home bias" in a host country's capital markets. These include bonding and signaling activities, organizational isomorphism, and endorsements by third parties. Although IB studies have identified some potential remedies of LOF when exploring firms' global product market strategies, we contend that our analysis may be equally important within international management and finance research focused on globalization of capital markets.

The remainder of this paper is organized as follows. In the next section, we discuss differences between product and capital markets in terms of liabilities of foreignness that firms may face when entering these markets. The following section introduces our theoretical model and discussion of sources of the CMLOF, including institutional distance, information costs, unfamiliarity costs and cultural differences. The next section discusses strategies for overcoming CMLOF. Finally, in addition to addressing CMLOF costs and strategies to mitigate their effects, investigating the internationalization of firms through capital markets can help to answer why firms engage in foreign expansion despite the prevalence of these costs that put them at a competitive disadvantage relative to local firms. In the last section, we offer a research agenda for the future investigation of CMLOF and conclude by discussing the implications for further research and theory development.

LIABILITY OF FOREIGNNESS IN CAPITAL MARKETS

The origins of the concept of LOF can be traced back to the works of Hymer (1976) who laid out the theoretical reasons why foreign firms are likely to incur additional costs that local firms would not incur and face competitive disadvantages. Hymer (1976) argued that foreign subsidiaries experience a competitive disadvantage due to fact that local firms have better information about the local competitive environment, including the economy, language, social needs and preferences, law, and politics. The study

of the systematic liabilities encountered by populations of firms due to factors that are by and large out of their control has parallels in population ecology research where considerable attention has been paid to the twin concepts of liabilities of newness and liabilities of smallness. Given the conceptual similarities between LOF and these other types of liabilities, Zaheer and Mosakowski (1997: 440) suggest, "liability of foreignness might need to stand alongside the other liabilities of age and size."

The most widely used definition of LOF in the literature is provided by Zaheer (1995: 343) who considers LOF as "all additional costs a firm operating in a market overseas incurs that a local firm would not incur." The focus of LOF is on the subtle structural/relational and institutional costs, or the social costs of access and acceptance. These social costs arise from unfamiliarity, relational, and discriminatory hazards with institutional distance as the key driver behind each of these costs (Eden & Miller, 2004).

The cumulative empirical evidence of prior research implies that, at least among firms competing in the product market domain, foreign-owned firms are expected to have lower profitability and a lower survival rate than local firms, ceteris paribus (see, e.g., Lord & Ranft, 2000; Zaheer & Mosakowski, 1997). It also suggests that LOF is prevalent across a wide range of product and service related industries such as banking, automobiles, and currency trading (Mezias, 2002) and that LOF has a negative impact on firm performance (Miller & Parkhe, 2002).

Sources of Liabilities of Foreignness and Mechanisms to Overcome Them

Based on a review of prior literature, Zaheer (1995) identified at least four sources of costs that put a foreign firm at a competitive disadvantage with local firms. First, these are spatial costs, which relate to costs arising from transportation and coordination. Even in a world where technology has shrunk distance and time, these costs are non-trivial. Second, there are costs that arise because of a firm's unfamiliarity with the local environment. As Caves (1971: 5) points out, "the foreign firm must pay dearly for what the native has acquired at no cost to the firm…..or can acquire more cheaply" as a result of its knowledge of the host country. Third, there are costs resulting from the host country environment due to the lack of legitimacy of the foreign firm as well as the prevalence of economic nationalism in

many countries. In addition, local consumers may be not familiar with the foreign firm's brand and products, and they would lean towards buying more familiar local brands even when their quality and prices do not match foreign entrants. Finally, there are costs arising out of the home country environment as well. For example, these may include restrictions on high technology exports, embargos on trade, and investment against specific countries among others.

Considerable empirical research has concentrated on the question of what firms can do to overcome LOF. Zaheer (1995) suggested mimicking the administrative practices of local firms as a possible response. Other suggestions include the choice of an appropriate entry mode (Eden & Miller, 2004), a combination of offensive (networking, legitimacy improvement) and defensive (contracts, output standardization) strategies (Luo, Shenkar & Nyaw, 2002) and the use of firm specific resources to outperform local rivals (Nachum, 2003).

Our review of LOF literature suggests that both its theoretical development and empirical analyses have been mostly confined to LOF associated with a product market entry by a foreign firm. However, firms often need external financial resources in order to capitalize on growth opportunities provided by their chosen product markets. The equity capital raised on the stock market is usually cheaper than private money and publicly traded shares are a useful currency in making acquisitions and helping a company to grow. Given the rapid globalization of capital markets, it is important to explore whether LOF applies to capital markets. And if it does, it is equally important to identify the sources of LOF in capital markets as well as the specific strategies that firms can pursue to reduce such liabilities.

Distinctions between Product and Capital Markets

Although there are many similarities between product and capital markets, there are also a number of important distinctions between them. Foremost among them are differences in information production, types of goods traded, the nature of the ongoing linkage between the buyers and sellers, and information intensity. First, product markets are characterized by consumption goods, whereas capital markets engage in the trading of investment and debt products. Although the seller's reputation is important in both markets, there are significant differences in terms of its effects on the buyers'

perceptions. More specifically, buyers of products associate reputation with the quality and durability of goods, whereas investors in stocks, bonds and other capital market instruments associate issuers' reputation with expected streams of future dividend and interest payments as well as potential appreciation of their investment in time. Second, the information production environments differ between the two markets. Capital markets can be largely considered as mediated markets in the sense that participants rely greatly upon endorsements by key third parties, such as investment banks, brokers, and investment analysts for information production.

Third, in the case of product markets, although organizational and product characteristics shape the purchasing decisions of buyers, once the purchase is completed the buyer's focus turns to the product itself rather than the producer. On the other hand, the connections that buyers of capital market securities have with issuers continue long after the sale, whether in primary or secondary markets. For instance, debt instruments involve scheduled payments of interest and loan principal over a certain period of time. Equities represent residual claim rights that, in theory, are valid throughout the firm's life span. The underlying value to buyers of both of these types of capital market securities is tied to the current and future activities of the issuer. Finally, along with differences in linkages, product and capital markets differ in terms of information intensity. Product markets typically involve one-time collection of information prior to purchase decisions. Capital markets, on the other hand, are extremely information intensive, especially in the periods after a particular security has been sold as the price of capital market instruments constantly change reflecting new information that becomes available.

Capital Markets and the Liabilities of Foreignness

The increasing integration of global capital markets now makes it easier for firms to raise both debt and equity capital from locations outside their home countries. This trend towards financial globalization has been facilitated by a number of regulatory and institutional developments. First, the establishment of stock exchanges in several major financial centers requiring lower levels of transparency of listed firms has enabled the entry of small and medium sized firms into global capital markets[ii]. Second, changes in regulations in many countries have given investors the opportunity to invest in foreign

equities. There is a variety of reasons why firms choose to seek equity financing outside of the home markets. In addition to the financial benefits, marketing and public relations benefits, political benefits, and employee relations benefits have been pointed out (Mittoo, 1992; Saudagaran, 1988). A successful listing in the U.S. can enhance operations or sales in the U.S., enhance analyst coverage, and provide firms with larger amounts of capital in order to pursue growth and acquisition strategies (see Karolyi, 2006 for a comprehensive review of the literature on foreign listings). By listing in a foreign market, firms can obtain access to more liquid markets, more easily attract debt capital at lower costs and better terms, and tap into a wider investor base than they would have in their home capital market (Claessens, & Schmukler, 2007).

LOF is inherently a relative construct in that its degree can only be assessed relative to host country competitors (Mezias, 2002). There is growing evidence regarding the prevalence of CMLOF in all types of capital markets, namely equity, debt, and venture capital. Yet, understanding what forms these liabilities can take and identifying their sources are vital to developing strategies for overcoming them. These liabilities may manifest in the form of higher costs of raising capital, lower liquidity of its securities, and tighter regulation of foreign firm's securities compared to their local counterparts. We discuss the manifestations of CMLOF in different capital market contexts below.

Equity Markets. A number of empirical studies suggest that firms face a variety of challenges in foreign equity markets compared to their local counterparts. Firms raising equity in a host country capital market may have to "underprice" its shares (Francis et al., 2010). Also, they could potentially pay higher underwriting fees, pay higher professional fees (e.g. costs to secure the services of legal advisors, auditors and independent directors), or higher initial listing fees, than local firms. For example, Bronson, Ghosh, and Hogan (2009) found that, after controlling for home country litigation environment, audit fees for firms cross-listed in the U.S. are 23 percent higher than those for U.S. firms. Similarly, differences in analyst coverage may result in lower trading volume, and therefore, reduced liquidity. Foreign firms experience difficulties in making themselves known to local investors (Bruner, Chaplinsky, & Ramchand,1999). In addition, foreign firms are subject to a greater frequency of lawsuits than local firms

(Bhattacharya, Galpin, & Haslem, 2007). Even more compelling evidence of CMLOF comes from a recent study by Frésard and Salva, (2010) who found strong support for the prevalence of a "foreign firm discount" relative to host market firms. They found that "All else being equal, the value of foreign firms with shares cross-listed on U.S. exchanges is around 14 percent lower than that of similar U.S. firms" (Frésard & Salva, (2010: 2). Their results are consistent with the findings of Aggarwal, Erel, Stulz, and Williamson (2009). Also, King and Segal (2008) show that Canadian firms that cross-list on U.S. stock exchanges experience a country discount relative to U.S. firms. Foreign firms may also be subject to more restrictive regulation than domestic firms. For example, the Russian firm Severstal was not allowed to issue shares to retail investors during an IPO in Hong Kong although it listed its shares in the local stock exchange.

Debt Markets. The largest component of the international capital market is the bond market. Between 1991-2005, 35% of all capital raised through debt issues was raised in markets other than the firm's home market (Gozzi, Levine, & Schmukler, 2010). Foreign firms raise significantly more debt than equity in the U.S. (Chaplinsky & Ramchand, 2004). Despite the well-documented attractions of global debt markets such as lower costs and lower underwriter compensation (Miller & Puthenpurackal, 2005) research also clearly shows that foreign firms are at a disadvantage compared to local firms in foreign debt markets. Indeed, there is extensive evidence that firms suffer from home bias when they try to source debt outside of their home market (Tesar & Werner, 1995). Atilgan, Ghosh, and Zhang (2010) found that not only do cross-listed bonds have lower initial ratings, but they are also less likely to be upgraded and take longer to be upgraded compared to U.S. domestic bonds with similar issuer and issue characteristics. These lower ratings are one of the clear manifestations of the prevalence of CMLOF in bond markets.

Venture Capital Markets. A growing body of research point to a number of factors that contribute to VCs choosing to make local rather than distant investments (Makela & Maula, 2008). Foremost among these reasons is the fact that VC firms tend to be deficient in local knowledge and lack of local network support. To protect their reputation and networks VCs favor local rather than distant ventures (Cumming

& Dai, 2010). Trust may affect VCs' international investment choices and institutional and cultural factors determine VC success internationally. Research has shown that cultural differences and geographical distance can create problems in cross-border VC investments and can diminish the commitment of venture capitalists in foreign markets (Mäkelä & Maula, 2008). Finally, due to the liability of foreignness, international VC firms originate fewer unsolicited deals from networks compared to domestic VCs (Qing & Hwang, 2010). Thus, a firm seeking venture capital outside of the country is likely to experience CMLOF either in terms of greater difficulty in obtaining capital, or less guidance by VC syndicates.

Despite the integration of capital markets, and the lowering of formal institutional barriers that have historically limited foreign ownership of firms around the world, finance researchers have consistently found that investors do not take advantage of the diversification benefits of foreign securities. For example, studies have shown that U.S. investors hold about 91 percent of their stock investments in domestic stocks—despite the fact that U.S. stocks represent only 49 percent of the world market portfolio (French & Poterba, 1991). Although economic theory suggests that international diversification would reduce portfolio risk, it has been repeatedly documented in the finance literature that both professional and individual investors hold too small portions of their wealth in foreign assets because of their preference for domestic over foreign assets (Cooper & Kaplanis, 1994; Tesar & Werner, 1995). Evidence by Chan et al. (2005) shows that the phenomenon is pervasive across 48 developed and developing countries worldwide. This is particularly intriguing because, unlike the trade in goods, transactions in financial markets do not incur spatial costs as there are low transportation costs. The preference shown by investors to overweight their portfolios with local securities and underweight foreign securities is generally referred to as "home bias" (French & Poterba, 1991). Even if a Chinese or Mexican firm lists its securities in the US or UK capital markets, investors in these countries still consider these as foreign securities because they are issued by foreign firms and may still continue to underweight them in their portfolios. This, in turn, can lead to lower trading volumes, lower security prices, and hence higher cost of capital.

ANTECEDENTS OF LIABILITIES OF FOREIGNNESS IN CAPITAL MARKETS

Foreign firms issuing securities overseas have to comply with a host market's security rules and regulations in the same way as local firms. However, their headquarters, operations, and business networks are often located in countries with different cultural and institutional environments. They also have to involve a wide range of intermediaries (e.g., bank-underwriters, rating agencies, etc.) to facilitate their approach to foreign investors. These factors, in addition to the transactional characteristics of a particular security, may affect investors' perceptions of the quality of the foreign firm's securities, and, ultimately, its CMLOF. They also may explain "home bias" identified in previous research.

Why would investors, who are assumed to be rational, forego the obvious benefits of portfolio diversification and continue to invest most of their funds in home markets? More importantly, how does the pervasive 'home bias' phenomenon impact the costs firms incur in their international capital raising activities? A number of explanations have been offered for the puzzling persistence of such suboptimal behavior by investors and these explanations provide valuable insights regarding the liabilities faced by firms in capital markets. Building on previous research on home bias in capital markets, we identify at least four major sources of CMLOF costs. These are institutional distance, information asymmetry, unfamiliarity, and cultural differences (Cai & Warnock, 2004; Chan et al., 2005; Tesar & Werner, 1995). Each of these is discussed next. We summarize these costs on the left side of our model in Figure 1.

Insert Figure 1 about here

Institutional Distance

Scott (1995: 33) defines institutions as "cognitive, normative, and regulative structures and activities that provide stability and meaning to social behavior." Institutional distance is defined as the degree of separation or extent to which institutions differ between countries (Xu & Shenkar, 2002). Substantial institutional differences create difficulties for foreign firms attempting to achieve legitimacy

in a host country (Kostova & Zaheer, 1999). Of the three dimensions of institutional environment mentioned above, the regulatory dimension is particularly salient in explaining LOF in capital markets. The regulatory dimension consists of the rules and laws that provide support for product and capital market participants and facilitate firms' efforts to acquire resources. A country's regulatory dimension can provide support for firms, including governmental regulations that structure competition within industries and rules and policies that structure transactions within capital markets. Regulative distance describes the differences in the general legal environments between home and host countries and higher regulative distance between two countries can discourage investors from one country to invest in another.[iii]

It is generally understood that when investors perceive that the risks and costs of acquiring and holding equities issued by foreign firms are sufficiently higher than they are for local securities, they will choose to keep their focus on local firms. These risks and costs arise primarily due to institutional differences between home and host country capital markets. For example, protections afforded to minority investors may be less in a foreign country compared to the investor's home country. As a result, investors would expect to be compensated for their higher risk through higher returns. In addition, when a firm comes from an institutionally distant country, host country investors may lack understanding of informal institutional settings in the home country, such as the level of corruption, and the importance of informal networks. Again, these factors increase risks and uncertainty associated with a foreign firm's equity, and, consequently, its CMLOF. There may be costs resulting from institutional barriers to trade assets. Each of these problems reduces the expected returns on foreign firms' assets relative to domestic assets, and hence, increases CMLOF for foreign issuers.

Despite the lowering of formal institutional barriers in recent years, research shows that home bias still remains. Studies by French and Poterba (1991), Tesar and Werner (1995), and Cooper and Kaplanis (1994) demonstrate that empirical support for a cost-based explanation for home bias is generally poor. The consensus is that differences in legal frameworks concerning, for example, accounting systems, corporate governance, restrictive investment regulations, or investor protection

persist and can likely explain at least part of the home bias (Chan et al., 2005). For example, Cai and Warnock (2006) found that the lower the level of investor protection in a country, the higher the home bias that firms from these countries would experience in foreign capital markets. Similarly, Ferreira and Matos (2008) found that institutional investors prefer stocks from countries with strong disclosure standards.

Similar logic applies when local investors provide capital to overseas companies. Although in theory there is no difference between the characteristics of securities issued by a foreign company in a host capital market and those issued by local companies, investors' sentiments towards these financial instruments may be driven by regulatory differences and costs associated with the foreign firm's country of origin. In particular, differences in the investor protection regimes may be translated into substantial CMLOF costs for companies coming from less "investor-friendly" countries. Hence, we suggest:

> *Proposition 1: There is a positive relationship between the institutional distance between a home and host country and the extent of CMLOF faced by a foreign firm.*

Information Costs

Finance researchers refer to information asymmetries to explain the puzzle of home bias in particular and patterns of transnational portfolio investments in general (Portes & Rey, 2005). Information asymmetry is present whenever one party in a transaction has more or better information than the other. In international financial markets, there is greater potential for an unequal distribution of information between national and foreign investors. An important source of such asymmetry is uncertainties regarding the codified rules regulating the behavior and activities of company insiders in foreign markets. In addition, information such as business practices and conventions, national cultures, and corporate cultures are required for investors to meaningfully evaluate foreign financial assets, but such information is often difficult to obtain and even more difficult to interpret.

In sum, local investors have better knowledge than their foreign counterparts about domestic firms. Investors often face high barriers to access information when attempting to evaluate foreign assets. Empirical evidence clearly suggests that information costs do indeed affect the composition of investors'

portfolios. For example, it has been found that foreign equity portfolios are skewed towards the equities of large firms (Kang & Stulz, 1997), information flows are an important determinant of cross-border equity transactions (Portes & Rey, 2005). These studies suggest that asymmetric information between local and non-local investors are an important factor for investment decisions. The logic of the above arguments that investors exhibit a home bias because of the prevalence of information asymmetries is equally applicable to decisions to invest in the equities of a foreign firm even if it is listed in the domestic stock exchange. Hence:

> *Proposition 2: There is a positive relationship between the host market investors' information costs and the extent of CMLOF faced by a foreign firm.*

Unfamiliarity Costs

Along with information costs, research has shown that firms must also contend with the fact that investors do not invest in firms they are not familiar with. It is found that investors tend to invest in a subset of eligible securities that they are familiar with, a phenomenon often referred to as a 'habitat effect' (Barberis, Shleifer, & Wurgler, 2005). Unfamiliarity costs are distinct from information costs in the sense that even if information costs are the same, when investors are choosing between two firms, they would prefer the firms that are relatively more familiar to them. Familiarity may arise from proximity, patriotism, name recognition, or a variety of other factors. Interestingly, familiarity can often have negative effects on returns. For example, Chan, Covrig, and Ng (2005) find strong support for irrational familiarity by revealing the overweighting of investment portfolios in investors' home markets, and under diversifying the capital that is left for foreign investment across a selected few "familiar" international markets.

Research also shows that the familiarity bias or local bias often manifests as a preference for geographic proximity. Coval and Moskowitz (1999) show that a geographic proximity effect works even within U.S. domestic stock portfolios. These authors demonstrate that mutual fund managers prefer to invest in firms headquartered close to their home cities. It has been shown that social identity triggered by group affiliations drives under-diversified and domestically biased portfolios. Investors

often prefer domestic assets to mimic the economic fortunes and welfare of their neighbors, countrymen, and social reference group. That emotions related to identity and nationalism may actually trump pure rationality in investment decisions is further evidenced by the "patriotism" in portfolio allocation decisions of U.S. investors reported by Morse and Shive (2007). This geographical bias suggests that investors will be particularly apprehensive when it comes to buying securities issued by foreign firms. This lack of familiarity can contribute to CMLOF costs.

Familiarity matters also at security level investment decisions and the decision to seek foreign capital. The important role familiarity plays in investment decisions has been extensively studied in recent years. Kang and Stulz (1997) show that foreign investors in Japan prefer large, international manufacturing firms. In a recent study of a large number of international funds with holdings in 11 developed countries, Covrig, Lau, and Ng (2006) investigated stock selection by domestic and foreign fund managers and found that domestic managers typically prefer smaller, high market-to-book firms. On the other hand, Cai and Warnock (2004) analyze foreign and domestic institutions' positions in US securities and find that both foreigners and domestic investors prefer large, internationally diversified firms. Therefore, foreign companies that do not fall under these categories may face additional costs of raising capital on a local capital market, hence increasing its CMLOF costs.

Familiarity with foreign markets on the part of managers plays a role in their decision on whether to seek capital resources abroad or where to seek it. For example, Sarkissian and Schill (2004) find that geographic proximity of the foreign market play a dominant role in selecting overseas listing destinations. In addition, the international experience of top management teams, international scope of operations, and industry have all been shown to be factors which prompt firms to seek equity resources outside their local capital markets (Blass & Yafeh, 2001; Hursti & Maula, 2007). While these findings suggest that internationalization increases the firm's visibility and decreases investors' unfamiliarity costs, research evidence clearly support the argument that investors prefer firms they are familiar with and that such familiarity often arises from size and proximity. Clearly, these place foreign firms at a distinct disadvantage in host country capital markets. Therefore, we suggest:

Proposition 3: There is a positive relationship between host market investor unfamiliarity with the foreign firm and its home country and the extent of CMLOF faced by a foreign firm.

Cultural Differences

Culture is often defined as a system of shared values, beliefs, and attitudes that influences individual perceptions and behaviors. Until very recently, nearly all research in economics has endogenized beliefs, under the rational expectations assumption that subjective and objective beliefs coincide (Guiso et al., 2009). However, in recent years, there has been a growing recognition that culture affects both economic exchange and outcomes by affecting expectations and preferences. Prominent among these studies is a new strand of literature that shows that perceptions rooted in culture are important and generally omitted determinants of economic exchange (Guiso et al., 2009). Indeed, culture affects the level of trust and nature of financial contracting. For example, level of trust may be related to amount of trade, portfolio investment, and direct investment. Trust within a country also affects household and firm level investment and lack of trust can affect stock market participation rates. Given the importance of culture in economic exchange, it is only natural that cultural differences between countries will have a significant impact on a wide variety of cross-border economic transactions.

Few concepts in international business have attracted as much application in diverse areas of research as cultural distance (Kogut & Singh, 1988). As Shenkar (2001) points out, the cultural distance construct has been applied to multiple research questions from innovation and transformation to foreign expansion and the ease of transferring technology across borders. While the impact of cultural difference on consumer and organizational behavior has received considerable research attention, it is increasingly being recognized that it may play an equally important effect on investor behavior.

In one of the first studies examining the importance of culture and investment behavior, Grinblatt and Keloharju (2000) found that investors are more likely to hold, buy, and sell the stocks of firms that are located close to the investor, that communicate in the investor’s native tongue, and have chief executives of the same cultural background. Subsequent studies have supported these findings. Morse and Shive (2007) show that cultures with high levels of patriotism have larger proportion of their

investments allocated at home. More recently Anderson et al. (2011: 930) found that "culture impacts investor behavior directly" even after controlling for geographical distance and regulatory differences. Additional support for culture's impact on investor behavior is provided by Beugelsdijk and Frijns (2010) who find that more uncertainty avoiding societies are associated with lower levels of foreign equity investment and that societies with higher levels of individualism invest more in foreign equities. Likewise, Chui, Titman, and Wei (2010) propose that cross-cultural differences in terms of individualism versus collectivism are related to trading activity levels and security pricing across countries. Chan, Covrig and Ng (2005) find that portfolio allocations of mutual funds depend upon both cultural and economic familiarity. When a country is more remote from the rest of the world and has a different language, foreign investors are reluctant to invest in that country. On the other hand, when a country is more developed, larger in market capitalization, and has lower transaction costs, foreign investors will invest more. Thus, a growing body of empirical evidence is accumulating that investor behavior is not entirely rational as originally believed and that cultural factors circumscribe investor rationality. Cultural differences can play a significant role in an individual's decision to invest in the stock of a company from a different country and can contribute to LOF costs even in financial markets.

Proposition 4: There is a positive relationship between the cultural differences between the host country and home country and the extent of CMLOF faced by a foreign firm.

MECHANISMS FOR OVERCOMING LIABILITIES OF FOREIGNNESS IN CAPITAL MARKETS

The existence of liabilities stemming from foreignness makes it an imperative for firms accessing international capital markets to engage in strategies designed to overcome these liabilities. While the problems of information asymmetry can be addressed to some extent with greater frequency and quality of disclosure and problems arising from unfamiliarity may diminish over time, one of the fundamental problems faced by foreign firms in international capital markets is what Schmidt and Sofka (2009) referred to as "legitimacy deficit." Attaining legitimate status is critical to both the short and long term success of firms in host capital markets. In the case of firms attempting to acquire resources in a host

country capital market, legitimacy would be the perception that the firm is similar to other host country firms in that market, or would act in a manner consistent with shareholder wealth generation, or is endorsed by organizations that are known and trusted. Legitimacy is particularly important in new ventures as it is critical to the ability to acquire other resources, including capital. This is because increased legitimacy has been associated with generating increased resource flows (Suchman, 1995). Hence, foreign firms have to engage in actions that increase their legitimacy in foreign capital markets. In this paper, we identify how four strategies - bonding, signaling, organizational isomorphism, and endorsements by reputable third parties - may moderate the relationship between the antecedent factors we discussed above and LOF in host capital markets. These strategies can be found in the middle of our framework in Figure 1.

Bonding

One of the biggest developments that have facilitated the entry of firms into global capital markets is the establishment of stock exchanges requiring lower levels of transparency. For example, in 1995 the Alternative Investment Market (AIM) was established in the U.K. to cater to the capital demands of small and medium sized firms. Since then, a number of the world's exchanges have started new trading platforms modeled after London's AIM market. Yet, while firms have increased access to equity and credit markets around the world through exchanges requiring lower levels of governance and transparency, simply listing on these exchanges may do little to reduce CMLOF costs. Starting with the influential papers by Coffee (1999) and Stulz (1999), the foreign listing literature in finance has argued that firms incorporated in countries with poor investor protection can credibly bond themselves to better investor protection by offering their shares in host markets with higher standards of investor protection. Offering shares on overseas markets as a means to improve a firm's corporate governance systems is often referred to as the 'bonding hypothesis'. Under the bonding hypothesis, opting for a listing in a more demanding exchange provides a means for foreign issuers to credibly commit to stricter regulation and the protection of investor rights against managerial self-dealing or excess consumption of private benefits of control (Coffee, 1999). In other words, offering shares on foreign exchanges can serve as a credible

bonding mechanism in that the firm will be subject to the increased scrutiny of multiple external monitors in the cross listing country. Even more important than the decision to list in a foreign market is the choice of the specific exchange. Different exchanges even within a country have different disclosure requirements and therefore in order to "bond" a firm will have to list its securities in an exchange that demands very high standards of disclosure and governance.

A number of studies show that bonding can help mitigate the costs firms face in foreign capital markets. Reese and Weisbach (2002) found that firms from countries with poor legal protections were more likely to list in the U.S. and, especially, on major U.S. exchanges. Doidge et al. (2004) documents a "cross-listing premium" of 16 percent for firms around the world that choose to cross-list in the U.S. Hail and Leuz (2009) found that firms with cross- listings on U.S. exchanges experience a decrease in their cost of capital between 70 and 120 basis points. Further, King and Segal (2008) demonstrate that Canadian firms cross-listing on U.S. exchanges reduce the country discount for Canadian firms relative to U.S. firms. Henderson, Jegadeesh, and Weisbach (2006) suggest that issuers from countries with less efficient capital markets tend to offer in countries with better liquidity and greater financial reform. Ammer et al. (2005) have shown that while U.S. investors hold 3 percent of the typical foreign firm that is not cross-listed on a U.S. exchange, U.S. investors hold 17 percent of those foreign firms that have cross-listed. This clearly indicates that investors react favorably when the firm engages in bonding.

Foreign firms that list on US exchanges "bond" themselves to the US regulatory regime, which provides higher investor protection than the firm's home market. By committing to stricter regulation the firm can enjoy greater access to capital markets. This occurs because, as Coffee (1999) argues, exposure to SEC enforcement and shareholder litigation decreases the principal-agency problem. Once foreign issuers list in capital markets that have stricter governance regulations than their own home market, the relative importance of variations between the corporate laws and corporate governance of different countries should decline in the minds of potential investors. Studies have shown that firms originating in countries with low investor protection levels can achieve a range of benefits by listing in markets that uphold minority shareholder rights. For example, listing in a host country with better investor protection

is associated with lower cost of capital (Hail & Leuz, 2009), more scrutiny by financial analysts (Lang et al., 2003), better access to external finance (Reese & Weisbach, 2002) and higher firm valuation (Doidge, et al., 2004). Thus, in addition to seeking larger market capitalization, greater liquidity, higher valuations, performance and foreign sales, legal bonding is part of the international capital raising decision for a growing percentage of foreign firms (Claessens & Schmukler, 2007). Hence:

Proposition 5: Bonding on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.

Signaling

Bonding hypothesis suggests that the firm may reduce its CMLOF by choosing a highly regulated host market. However, even in less regulated markets a firm can mitigate negative effects of CMLOF by signaling its quality to investors. The importance of signals in capital markets has long been recognized, especially in research on the pricing of IPOs. Researchers have focused upon uncovering a range of signals associated with the IPO firm that managers employ to convey its value to potential investors (Certo et al., 2001; Filatotchev & Bishop, 2002; Sanders & Boivie, 2004). IPOs are characterized by information asymmetry in which owners have more complete information than investors regarding the quality of the firm. We believe that many of the signals identified in IPO literature may be equally efficacious in reducing CMLOF.

To combat the investors' lack of information about a firm, a number of organizational attributes can serve as indicators of the value of an organization when it approaches public market investors. For example, IPO studies emphasize signaling properties of revealed risk (Beatty & Zajac, 1994), and the specific ways in which the proceeds of the issue would be used (Beatty & Ritter, 1986). In addition, corporate governance characteristics also have come to be regarded as important signals of governance quality. The various such signals identified in IPO research include insider ownership (Certo, Daily, Cannella, & Dalton, 2003), equity ownership by outside directors and institutional block holders (Sanders & Boivie, 2004), and founder as CEO (Certo, Covin, Daily, & Dalton, 2001). Board independence is

increasingly recognized as leading to more effective monitoring and hence can serve as a signal of good governance (Filatotchev & Bishop, 2002). Good governance signals are costly and poor quality firms are less likely to spend their resources on trying to send these signals. Given that cross-listings and IPOs are the two primary means by which firms access foreign equity markets, a number of governance signals would prove to be useful in reducing the level of CMLOF experienced by a firm. By signaling its value through good corporate governance, the firm may differentiate itself from other firms from the same country, and, therefore, reduce costs associated with CMLOF. Therefore, we suggest:

> *Proposition 6: Signals of good governance on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

Organizational Isomorphism

Isomorphism in organizational fields is a central concept of institutional theory (DiMaggio & Powell, 1983). Organizations seek to attain legitimacy through mimetic processes that result in their becoming similar to other organizations in an organizational field (DiMaggio & Powell, 1983). Generally speaking, legitimacy may be considered a generalized perception that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, and beliefs. Firms considered legitimate by market stakeholders tend to succeed more frequently in competitive capital markets (Suchman, 1995). In fact, legitimacy is considered even more important for emerging firms entering a market because the organization's chances of survival are significantly enhanced (Rao, 1994). Similarly, LOF studies have also emphasized the importance of mimicking, or conformity relative to local firms to the performance of foreign subsidiaries (Miller & Eden, 2006). Zaheer (1995: 344) also highlights the importance of local isomorphism by suggesting that in the absence of firm-specific advantages, foreign firms need to "mimic the advantages of successful local firms."

Foreign companies from specific industries can overcome information and knowledge gaps by opting for markets where investors and analysts have an understanding and proven expertise in these industries. Particularly in technology or higher-risk sectors, the availability of such skills may substantially affect the availability of equity finance and the terms at which it is available. Better analyst

coverage of such industries is likely to broaden understanding in the primary market, promote investor interest, and ultimately deliver higher valuations of the companies. If industry expertise is an important determinant of where to list and raise capital, one would expect to observe companies in the same industry clustered in exchanges that deliver this expertise. Previous studies have indeed found that companies opt for listings where industry peers are already present (Pagano et al., 2002) because of the low costs of information transfer. While the NYSE and NASDAQ exchanges provide trading platforms for the largest number of leading high-technology companies whose shares enjoy worldwide visibility and liquidity, Toronto's TSX and London's AIM exchanges have the most sophisticated and mature mining finance markets in the world, whereas the Hong Kong stock exchange is the destination market of choice for Chinese state-controlled companies seeking capital. As these examples demonstrate, it is not uncommon for firms to seek capital markets where similar firms are already established and understood by resource holders. As Hursti and Maula (2007: 838) point out "seeking an investor base that 'understands' the business of the IPO candidate is often cited as the reason for listing overseas." Hence, it is through a careful examination of their social identity that firms can potentially achieve legitimate status with influential capital market actors. As a result, this enhanced legitimization may lead to a reduction of its CMLOF.

> *Proposition 7: Organizational isomorphism on the part of the foreign firm negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

Certification by Information Intermediaries

As Rao (1994: 31) notes "the very act of endorsement embeds an organization in a status hierarchy and thereby builds the reputation of an organization". The value of third party endorsements (e.g., prestigious underwriters, audit firms, and alliance partners) in reducing the degree of uncertainty surrounding security issues is built upon the social status of the certifying organization. Therefore, a relationship with a high-status partner can be considered a powerful endorsement for the unfamiliar firm and thus act as a reputational source of legitimacy.

A wide assortment of organizational and extra-organizational attributes that serve as important cues regarding the quality of an unfamiliar firm to capital market resource providers have been investigated in prior research. Coffee (1999) and Stulz (1999), emphasize the role of "reputational intermediaries" in U.S. markets. These intermediaries include underwriters (in the case of capital-raising listings), auditors, debt-rating agencies, securities analysts as well as the exchanges themselves (via listing requirements). They provide additional scrutiny or monitoring that is unavailable in the home markets of foreign firms. These local actors are attractive to foreign investors, because they reduce information asymmetry, add value, and provide legitimacy. They have information about the operation of the local market, including access to deal flow as well as dense networks of contacts and also have considerable familiarity with the legal requirements of the local market.

This analysis suggests that foreign firms can reduce their CMLOF by using means external to an organization, such as endorsements and certifications by third parties (banks-underwriters; audit firms, private equity investors, etc.). However, the extent of this endorsement effect is contingent on the institutional infrastructure of local capital markets. In some markets, such as the U.S. stock markets, formal arrangements with bank-underwriters and other third parties who act as "gate keepers" may be particularly salient means of reducing CMLOF among foreign firms attempting to issue local securities.

> *Proposition 8: Endorsements of the foreign firm by reputable third parties negatively moderates the relationship between antecedent factors and the extent of CMLOF faced by a foreign firm.*

DISCUSSION

Liability of foreignness has been one of the most researched topics in international business since the beginning of the field in the early 1960s. LOF is central to the development of theories of the multinational firm, but most such theories accorded LOF what amounts to a "taken for granted" status. Starting with the pioneering work of Zaheer (1995), the last fifteen years have seen a sudden proliferation of empirical and theoretical work on LOF and many stimulating intellectual debates on the domain of the construct, its measurement, and strategies for overcoming it. Our study goes beyond product markets and

draws attention to issues of LOF faced by the growing number of firms that choose to seek capital resources outside of their home capital markets. We develop a framework to understand both the sources of CMLOF and strategies that firms can use to mitigate those costs.

Our study draws from the pervasiveness of the 'home bias' phenomena among investors around the world to explain how firms incur additional costs when raising funds outside of their home capital markets. As firms rush to cross-list their stock in multiple markets and choose to make their capital market debut in foreign markets through IPOs, it becomes important to examine the existence of LOF in capital markets. We identify four major types of costs that result in LOF in capital markets. These are institutional distance, information costs, unfamiliarity costs, and costs arising from cultural differences. Each of these places the foreign firm at a disadvantage compared to domestic firms in host capital markets. Drawing from institutional and signaling theories we identified four specific strategies that firms can use to overcome CMLOF. These are bonding, signaling, organizational isomorphism, and endorsements by third parties. Together these strategies enhance the legitimacy of the foreign firm and level the playing field with respect to local firms vying for capital resources.

Expanding the scope of LOF research to include the costs facing firms acquiring resources in host capital markets presents a number of exciting research opportunities. These include the role of institutional context, potential interactions between product and capital markets and their implications for CMLOF, identification of situations where foreignness may convey benefits rather than liabilities, the substitutability and complementarities among the mitigation strategies, and the exploration of CMLOF in informal capital markets. Further, the advancement of empirical research on CMLOF requires the development of operational measures that are reliable, valid, and easy to use. Each of these issues is discussed next.

The recent accumulation of research on the role of institutional context suggests that success of specific strategies firms employ to mitigate CMLOF costs may be a function of the institutional characteristics of the host country. For example, certain governance signals, such as stock-based executive compensation is so prevalent in the U.S. that it has achieved a "taken for granted status"

(Sanders & Boivie, 2004: 171) whereas this form of governance signal may be less accepted in other host capital markets. Likewise, large investment banks are relevant social actors in the US capital market, and could conceivably confer legitimacy to foreign firms seeking capital on US exchanges. As these examples suggest, it is important to recognize that the ability of governance signals and endorsement to reduce LOF costs may be contingent on both home and host institutional environments. Therefore, the impact of the institutional environment of a country on the likelihood of success of specific strategies to overcome CMLOF is a promising avenue for further research.

A growing body of research in the finance area suggests that there are information spillovers from product markets to capital markets. It has been found that individual investors prefer to invest in stocks with easily recognized products and less likely to sell shares of companies they frequent as customers (Frieder & Subrahmanyam, 2005). It has also been found that a firm's advertising expenditures is related to number of both individual and institutional investors as well as liquidity for their common stock and higher stock valuation (Chemmanur & Yan, 2009). The possibility of interaction between product and capital markets has been demonstrated in the international context as well. A number of studies show that greater trade between two countries results in increased cross-border asset holdings (Portes & Rey, 2005). Research by Sarkissian and Schill (2004) shows that firms choose to raise capital in countries where their products are known. On the other hand, Pagano et al. (2002) argue that a cross-listing can strengthen the competitive position of a firm in its industry and increase its foreign sales by enhancing the firm's brand recognition, and reputation with suppliers, employees, and customers. Further, firms may decide to raise capital abroad so that their products can become better known in foreign markets. Given that LOF exists in both product and capital markets, an investigation of their interactions would be an important area for future research.

Although our discussion in this paper is built on the implicit assumption that foreignness carries with it inherent liabilities, there may indeed be specific situations where foreignness may actually prove beneficial. First, in the capital market context, investors seek diversification to reduce the risk of their portfolios. Thus, investors are actively looking for foreign stocks and thus foreignness becomes

attractive. Foreign IPOs, cross-listed stocks, and ADRs are particularly attractive in this regard because they provide an investor with an easier way to invest in foreign equities without incurring the transaction costs of buying a foreign security. Second, there is a significant body of research in marketing that has investigated "country-of-origin" (COO) effects (Peterson & Jolibert, 1995). COO is an extrinsic product cue that influences a customer's decision to buy or not buy a product. COO effects can be either positive or negative. For example, French wine, Swiss chocolate and German automobiles carry with them very favorable images. Similarly, when a country is deemed as "hot," debt and equity instruments issued by firms from that country might actually enjoy very favorable response from investors in foreign capital markets. Finally, foreignness can be a benefit when local firms are viewed as less legitimate or even illegitimate (Kostova & Zaheer, 1999). While there are benefits to foreignness as described above, our review of empirical research in finance clearly indicates that the liabilities of foreignness outweigh the benefits. For example, Foerster & Karolyi (2000) found that foreign issues underperformed local market benchmarks of comparable firms by 8 to 15 percent over three years following issuance.

Recent research indicates that corporate governance factors should not be considered in isolation from each other, but instead they should be examined as 'bundles' of corporate governance practices that are aligned with one another and mutually enhance the effectiveness of those practices. In a similar fashion, our paper has treated the mitigation strategies as a bundle which together could alleviate CMLOF. Future research should evaluate how these legitimation strategies can complement or perhaps substitute for one another.

Much of our discussion in this paper was restricted to CMLOF in formal equity markets because firms have traditionally gained access to capital via public capital markets. However, private equity represents an innovation in the ability to provide capital to unquoted firms. Hence, future research could explore the occurrence of CMLOF within informal capital markets. For example, foreign private equity firms entering overseas markets may face higher transactions costs in both identifying and monitoring firms to invest in. By virtue of their foreignness, they also likely experience greater information asymmetries. In addition, studies have shown that CMLOF can have significant impacts on cross-border

venture capital activity. Indeed, cultural differences and geographical distance can create problems in cross-border VC investments and can diminish the commitment of venture capitalists in foreign markets (Guler & Guillen, 2010; Mäkelä & Maula, 2008). Future analysis can usefully integrate institutional theory and economic sociology research to develop a more holistic view on the antecedent factors and moderators of LOF in different institutional contexts.

The development of operational measures for CMLOF is critical to advancing empirical research on this topic. There are a number of dimensions along which firms could face challenges that are different from what local firms would face, when raising either debt or equity in foreign markets. For example, in the case of foreign IPOs and cross-listings, the foreign firm's cost of capital compared to local firms may provide a benchmark for LOF. In addition, the extent of underpricing relative to local firms after controlling for other firm-specific and industry-specific factors could be a promising measure. Also, differences in analyst coverage, trading volume, and investor law suits could provide some indication of LOF. Differences in underwriting fees, if any, and differences in the quality and prestige of underwriters and auditors backing firms seeking equity resources in foreign capital markets are other potential indicators. We suggest that another promising way to measure LOF would be to compare delisting rates between local and foreign firms. In the debt market, comparisons of credit ratings, cost of debt, and underwriter expense could all be potential indicators of CMLOF. Finally, in the case of Venture Capital, access to such capital, size of syndicate, and number of rounds of financing could each provide some measure of the additional challenges that new venture face. While it is premature to converge on a single indicator of LOF in capital markets, the careful examination of many of the indicators suggested above can potentially provide valuable insights into the existence of LOF and its magnitude.

In this paper we argued for the expansion of the domain of the liabilities of foreignness construct to include liabilities faced in capital markets. The increasingly integrated global capital markets have greatly impacted the opportunities available to firms worldwide seeking to lower their costs of capital. However, a significant body of literature has demonstrated a pervasive bias among investors against firms founded in dissimilar cultural and institutional environments. Indeed, overcoming investor bias

represents real costs to the firm and is a steep challenge to the manager looking to acquire capital resources abroad. We identify a number of causes for investor bias and the resulting CMLOF and suggest a range of strategic responses that firms can employ to overcome them. Future empirical validation of the applicability of these mitigation strategies will help firms to develop more effective strategies when accessing resources in foreign capital markets.

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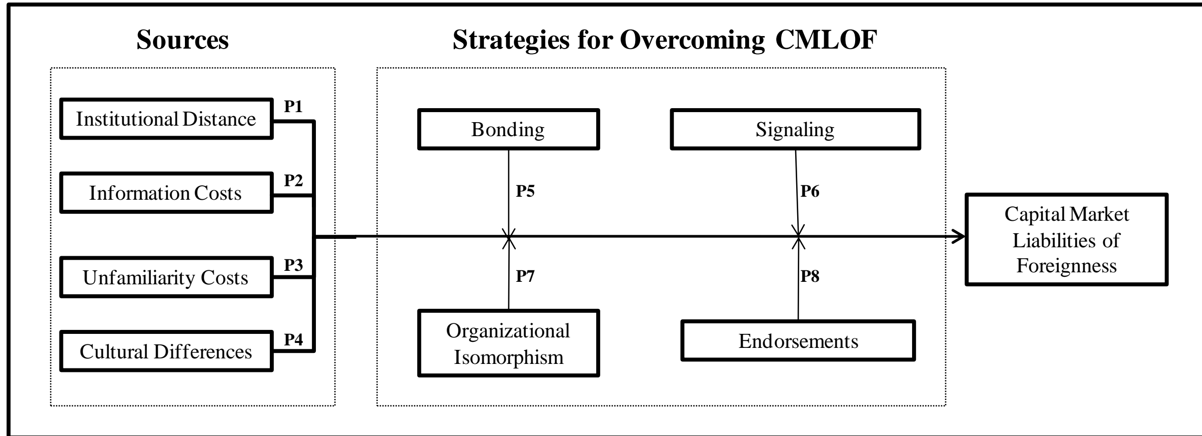
Figure 1 Capital market liabilities of foreignness: Antecedent factors and mitigation strategies



NOTES

[i] The majority of our discussion is restricted to equity markets since a rapid integration of equity markets was the most pronounced globalization phenomenon over the past decade.

[ii] For instance, the London Stock Exchange introduced the AIM and the Borsa Italiana introduced in early 2009 the AIM Italia. The Deutsche Borse contains the Freiverkehr, which is modeled after London's AIM with lower listing requirements. Similarly, Prague, Hong Kong, and Singapore have also subdivided their primary markets in order to compete for small and medium sized firms attempting to acquire capital resources.

[iii] Interestingly, the impact of institutional distance between two countries on investor behavior may often be asymmetrical. That is, a Columbian investor may have more information about the U.S. institutional context than a U.S. investor may have about Columbia. Thus, institutional distance may not affect the behavior of the investors in the two countries equally.