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Shareholder rights and the market reaction to Sarbanes-Oxley

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Abstract

The Sarbanes-Oxley Act of 2002 (SOX) was aimed at enhancing corporate governance, financial reporting, and audit functions. This study compares the market reaction of firms with weak and strong protection of shareholder rights to the passage of SOX. We find that firms with weak shareholder rights experienced positive abnormal returns when SOX was passed. This is consistent with the market perceiving that such firms would benefit from the governance reforms. In contrast, firms with strong shareholder rights did not experience a significant positive market reaction. We also find a significant increase in risk for firms with weak shareholder rights following the passage of SOX. In addition, we find that strong shareholder rights firms decreased shareholder protection after SOX, while weak shareholder rights firms did not change significantly from their pre-SOX protection levels. We find no evidence of abnormal long-run performance for firms that altered their shareholder protection following SOX.

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1. Introduction

The separation of ownership and control in corporations has long been a topic of great interest to financial economists. Agency conflicts arise when a manager's private goals are inconsistent

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with maximizing shareholder wealth (Jensen & Meckling, 1976). However, various mechanisms are designed to protect shareholder interests, including the board of directors, the external auditor, and managerial compensation contracts. While these and other mechanisms are often helpful in reducing agency problems, recent corporate and accounting scandals, including Enron, WorldCom, Qwest, Tyco, and Global Crossing, highlight that current governance structures are not always failsafe. In all of these cases, managers deliberately misled shareholders and the boards and auditors failed to correct the problems. These scandals challenged the confidence of investors in corporate governance, financial reporting, and related auditing functions.

To restore public confidence, Congress passed the Sarbanes-Oxley Act of 2002 (SOX). The stated objective of SOX is "to protect investors." Lawmakers believed that new regulations were necessary to make corporations more accountable to shareholders. SEC Commissioner, Harvey Goldschmid, referred to SOX as the "most sweeping reform since the Depression-era Securities Laws" (Murray, 2002) and President Bush called SOX "the most far-reaching reforms of American business practice since the time of Franklin Delano Roosevelt" (Bumiller, 2002).

SOX requires significant reforms in corporate governance, financial disclosure, and the practice of public accounting. The legislation is broad and establishes new or enhanced standards for all US public company boards, management, and public accounting firms. More specifically, SOX establishes new standards for corporate boards and audit committees, establishes new accountability standards and criminal penalties for corporate management, establishes new independence standards for external auditors, establishes a Public Company Accounting Oversight Board (PCAOB) under the SEC to oversee public accounting firms and issue accounting standards. As Rezaee and Jain (2003) note, some of the effects of the changes are likely to be felt gradually by companies (such as the PCAOB, attorney reporting, and audit committee changes) but many of the other provisions had an immediate affect on companies (such as reporting requirements, executive certifications, and actions prohibiting fraudulently influencing an audit or loans to officers and directors).

In contemporaneous studies, scholars have begun to examine the market reaction to the passage of SOX. Li, Pincus, and Rego (2004) find significantly positive stock returns associated with the events that resolved the uncertainty about SOX's final provisions. Likewise, Rezaee and Jain (2003) show a positive stock price reaction on several dates leading up to the passage of SOX. However, neither of these studies considers that the market reaction should differ based on whether the firm already had an effective governance structure in place. To illustrate, for a company with a governance structure that was already effective at protecting shareholder interests, the passage of SOX would be unlikely to convey significant benefits. In fact, given the substantial costs of complying with SOX, such firms may experience a negative reaction to its passage if the additional controls are seen as redundant monitoring. In contrast, for firms with weak governance structures or those that did not protect shareholder interests, SOX is likely provide shareholders with additional benefits, suggesting such firms should experience a positive stock price reaction. The benefits of SOX for such firms are likely to exceed the costs of compliance and thus the market reaction is expected to be positive.

Akhigbe and Martin (2006) do consider that market reactions may differ for firms requiring more or less monitoring by examining financial services firms. These firms are regulated and thus may need less monitoring. However, they find a positive market reaction by financial services firms to SOX. In addition, they show that the market reaction varied by the firms' governance and disclosure characteristics, suggesting that the market reaction differed for firms directly affected by SOX. However, they do not consider the broad issue of shareholder rights. Chhaochharia and Grinstein (2005) focus on four aspects of corporate behavior that all the rule changes passed in