

The Sarbanes-Oxley Act of 2002 and Market Liquidity

Pankaj K. Jain, Jang-Chul Kim ✉, Zabihollah Rezaee

First published: 08 July 2008

<https://doi.org/10.1111/j.1540-6288.2008.00198.x>

Citations: 52

We are grateful for the comments and suggestions from participants at the 14th Annual Conference of Financial Economics and Accounting (CFEA) at Indiana University, the 2003 Mid-South Doctoral Research consortium, the 2003 Annual Meeting of the Financial Management Association International (FMA), and the 2004 Annual Meeting of the American Accounting Association. We also appreciate the comments from two anonymous reviewers and the editor, Arnie Cowan.

Abstract

Investors rely heavily on the trustworthiness and accuracy of corporate information to provide liquidity to the capital markets. We find that the rash of financial scandals caused a severe deterioration in market liquidity in the form of wider spreads, lower depths, and a higher adverse selection component of spreads vis-à-vis their benchmark levels. Regulatory responses including the Sarbanes-Oxley Act of 2002 (SOX) had inconsequential short-term liquidity effects but highly significant and positive long-term liquidity effects. These liquidity improvements are positively associated with the improved quality of financial reports, several firm-specific variables (e.g., size), and market factors (e.g., price, volatility, volume).

References

Anderson, K.L. and T.L. Yohn, 2003. The effect of 10-K restatement on firm value, information asymmetries, and investors' reliance on earnings. *Working paper*, Georgetown University .

[Google Scholar](#)

Bacidore, J., R. Battalio, and R. Jennings, 2003. Order submission strategies, liquidity supply, and trading in pennies on the New York Stock Exchange, *Journal of Financial Markets* 6, 337–362.

[Web of Science®](#) | [Google Scholar](#)

Boehmer, E., G. Saar, and L. Yu, 2005. Lifting the veil: An analysis of pre-trade transparency at the NYSE, *Journal of Finance* 60, 783–815.

[Web of Science®](#) | [Google Scholar](#)

Bushee, B.J. and C. Leuz, 2005. Economic consequences of SEC disclosure regulation: Evidence from the OTC bulletin board, *Journal of Accounting and Economics* 39, 233–264.

[Web of Science®](#) | [Google Scholar](#)

Chakravarty, S., R. Wood, and R. Van Ness, 2004. Decimals and liquidity: A study of the NYSE, *Journal of Financial Research* 27, 75–94.

[Google Scholar](#)

Chiyachantana, C.N., C.X. Jiang, N. Taechapiroontong, and R.A. Wood, 2004. The impact of Regulation Fair Disclosure on information asymmetry and trading: An intraday analysis, *The Financial Review* 39, 549–577.

[Google Scholar](#)

Coates, J.C., 2007. The goals and promise of the Sarbanes-Oxley Act, *Journal of Economic Perspectives* 21 (Winter): 91–116.

[Web of Science®](#) | [Google Scholar](#)

Cohen, D.A., A. Dey, and T.Z. Lys, 2004. The effect of the Sarbanes-Oxley Act on earnings management: What has changed 2004 Annual Meeting of the American Accounting Association (AAA). Orlando , FL . August 8–11.

[Google Scholar](#)

Committee on Capital Markets Regulation, 2006. Interim report of the Committee on Capital Markets Regulation (November 30). <http://www.capmksreg.org/research.html>.

[Google Scholar](#)

Crutchley, C.E., M.R.H. Jensen, and B.B. Marshall, 2007. Climate for scandal: Corporate environments that contribute to accounting fraud, *The Financial Review* 42, 53–73.

[Google Scholar](#)

Cunningham, L.A., 2003. The Sarbanes-Oxley yawn: Heavy rhetoric, light reform (and it just might work), *Connecticut Law Review* 35 (Spring), 915–988.

[Google Scholar](#)

Dechow, P. and I. Dichev, 2002. The quality of accruals and earnings: The role of accrual estimation errors. *Accounting Review* 77(Supplement), 35–59.

[Web of Science®](#) | [Google Scholar](#)

Diamond, D.W. and R.E. Verrecchia, 1991. Disclosure, liquidity, and the cost of capital, *Journal of Finance* 46, 1325–1359.

[Web of Science®](#) | [Google Scholar](#)

Donaldson, W.H., 2005. Speech by SEC Chairman: Remarks before the Financial Services Roundtable. *U.S. Securities and Exchange Commission* (April 1). <http://www.sec.gov/news/speech/spch040105whd.htm>.

[Google Scholar](#)

Easley, D. and M. O'Hara, 1992. Time and the process of security price adjustment, *Journal of Finance* 47, 577–605.

[Web of Science®](#) | [Google Scholar](#)

Eleswarapu, V.R., R. Thompson, and K. Venkataraman, 2004. The impact of Regulation Fair Disclosure: Trading costs and information asymmetry, *Journal of Financial and Quantitative Analysis* 39, 209–225.

[Web of Science®](#) | [Google Scholar](#)

Findlay, S. and P.G. Mathew, 2006, An examination of the differential impact of regulation fd on analysts' forecast accuracy, *The Financial Review* 41, 9–31

[Google Scholar](#)

Forbes, 2002. *The Corporate Scandal Sheet*. <http://www.forbes.com/home/2002/07/25/accountingtracker.html>.

[Google Scholar](#)

Glosten, L.R. and L.E. Harris, 1988. Estimating the components of the bid-ask spread, *Journal of Financial Economics* 21, 123–142.

[Web of Science®](#) | [Google Scholar](#)

Glosten, L.R. and P.R. Milgrom, 1985. Bid, ask, and transaction prices in a specialist market with heterogeneously informed traders, *Journal of Financial Economics* 14, 71–100.

[Web of Science®](#) | [Google Scholar](#)

Harris, M. and A. Raviv, 1993. Differences of opinion make a horse race, *Review of Financial Studies* 6, 473–506.

[Web of Science®](#) | [Google Scholar](#)

Heflin, F., K.W. Shaw, and J.J. Wild, 2002. Disclosure quality and market liquidity. *Working paper*, Robert H. Smith School of Business .

[Google Scholar](#)

Hribar, P. and D.W. Collins, 2002. Errors in estimating accruals: Implications for empirical research, *Journal of Accounting Research* 40, 105–134.

[Web of Science®](#) | [Google Scholar](#)

Huang, R.D. and H.R. Stoll, 1996. Dealer versus auction markets, *Journal of Financial Economics* 41, 313–357.

[Web of Science®](#) | [Google Scholar](#)

Huang, R.D. and H.R. Stoll, 1997. The components of the bid-ask spread: A general approach, *Review of Financial Studies* 10, 995–1034.

[Web of Science®](#) | [Google Scholar](#)

Jain, P.K. and Z. Rezaee, 2006. The Sarbanes-Oxley Act of 2002 and security market behavior: Early evidence, *Contemporary Accounting Research* (Autumn) 23, 629–654.

[Web of Science®](#) | [Google Scholar](#)

Jo, H. and Y. Kim, 2007. Disclosure frequency and earnings management, *Journal of Financial Economics* 84 (May), 561–590.

[Web of Science®](#) | [Google Scholar](#)

Kyle, A., 1985. Continuous auctions and insider trading, *Econometrica* 53, 1315–1335.

[Web of Science®](#) | [Google Scholar](#)

La Porta, R., F. Lopez-De-Silanes, A. Shleifer, and R. Vishny, 1998. Law and finance, *Journal of Political Economy* 106, 1113–1155.

[Web of Science®](#) | [Google Scholar](#)

La Porta, R., F. Lopez-De-Silanes, A. Shleifer, and R. Vishny, 2002. Investor protection and corporate valuation, *Journal of Finance* 57, 1147–1170.

[Web of Science®](#) | [Google Scholar](#)

Lee, C.M.C., B. Mucklow, and M.J. Ready, 1993. Spreads, depths, and the impact of earnings information: An intraday analysis, *Review of Financial Studies* 6, 345–374.

Li, H., M. Pincus, and S.O. Rego, 2008. Market reaction to events surrounding the Sarbanes-Oxley Act of 2002 and earnings management, *Journal of Law and Economics* (forthcoming).

[Google Scholar](#)

Myers, S. and N. Majluf, 1984. Corporate financing and investment decisions when firms have information that investors do not have, *Journal of Financial Economics* **13**, 187-221.

[PubMed](#) | [Web of Science®](#) | [Google Scholar](#)

Osterland, A., 2002. No more Mr. Nice Guy: A CFO survey suggests that recently passed rules for auditors may be a wise idea, *CFO Magazine*, pp. 1-7. <http://www.cfo.com/article.cfm/3006158?f=search>.

[Google Scholar](#)

Rezaee, Z., 2002. *Financial Statement Fraud: Prevention and Detection* (John Wiley & Sons, New York).

[Google Scholar](#)

Rezaee, Z., 2004. Corporate governance role in financial reporting, *Research in Accounting Regulation* **17**, 107-149.

[Google Scholar](#)

Sarbanes-Oxley Act of 2002. The Public Company Accounting Reform and Investor Protection Act. <http://www.whitehouse.gov/infocus/corporateresponsibility>. (H.R. 3763).

[Google Scholar](#)

Sarbanes, P., 2006. Senator Paul S. Sarbanes' Remarks on the Sarbanes-Oxley Act before Consumer Federation of America Lifetime Consumer Hero Award (March 23). <http://www.uspirg.org/consumer/archives/sarbanescfa.pdf>.

[Google Scholar](#)

White, H., 1980. A heteroskedasticity-consistent covariance estimator and a direct test for heteroskedasticity, *Econometrica* **48**, 817-838.

[CAS](#) | [Web of Science®](#) | [Google Scholar](#)

ABOUT WILEY ONLINE LIBRARY

[Privacy Policy](#)

[Terms of Use](#)

[About Cookies](#)

[Manage Cookies](#)

[Accessibility](#)

[Wiley Research DE&I Statement and Publishing Policies](#)

[Developing World Access](#)

HELP & SUPPORT

[Contact Us](#)

[Training and Support](#)

[DMCA & Reporting Piracy](#)

OPPORTUNITIES

[Subscription Agents](#)

[Advertisers & Corporate Partners](#)

CONNECT WITH WILEY

[The Wiley Network](#)

[Wiley Press Room](#)

Copyright © 1999-2024 John Wiley & Sons, Inc or related companies. All rights reserved, including rights for text and data mining and training of artificial intelligence technologies or similar technologies.

WILEY