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The Sarbanes-Oxley Act of 2002 and Market Liquidity

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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).

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