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The Sarbanes Oxley Act of 2002: Implications for Compensation Contracts and Managerial Risk-Taking

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Daniel A. Cohen (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=118206)

Vanderbilt University - Owen Graduate School of Management

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Abstract

The Sarbanes Oxley Act of 2002 (SOX) introduced several governance reforms that considerably increased the total risk exposure of CEOs. We examine the effects of these regulatory changes on compensation contracts of CEOs and their effect on risk taking subsequent to SOX. We find that while overall compensation did not change, salary and bonus compensation increased and option compensation decreased following the passage of SOX. The sensitivity of CEO's wealth to changes in shareholder wealth also decreased after SOX. These results indicate that the pay for performance sensitivity of CEO compensation has declined following SOX. Our results indicate that these changes reduced investments in research and development, and capital expenditures. We also document that the above changes in CEOs pay for performance sensitivities and their risky investments following SOX are associated with a reduction in stock return volatility. However, we do not find any evidence indicating that these changes are associated with lower future operating performance.

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