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

NYU Working Paper No. 2451/27546

44 Pages
Posted: 8 Oct 2008

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Date Written: July 2004

Abstract

The Sarbanes Oxley Act of 2002 (SOX) introduced several governance reforms thatconsiderably 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 passageof SOX. The sensitivity of CEO s wealth to changes in shareholder wealth also decreasedafter SOX. These results indicate that the pay for performance sensitivity of CEOcompensation has declined following SOX. Our results indicate that these changesreduced investments in research and development, and capital expenditures. We also document that the above changes in CEOs pay for performance sensitivities and theirrisky investments following SOX are associated with a reduction in stock returnvolatility. However, we do not find any evidence indicating that these changes areassociated with lower future operating performance.

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