THE EFFECT OF THE SARBANES-OXLEY ACT AND CD&A RULE ON COMPENSATION STRUCTURE AND HEDGING DECISION OF CROSS-LISTED FIRMS

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dx.doi.org/10.18374/IJBR-20-3.6

ABSTRACT

This study explores possible effects of seeking to impose rules on cross-listing firms that are already subject to equivalent or superior measures under their domestic regime. We expect that cross-listed firms (particularly when they are located in English legal origin countries) will alter the performance-based compensation to fixed compensation awarded to corporate executives under increased regulation scrutiny by SOX and CD&A Rule. Moreover, SOX enhanced transparency and disclosure of derivatives use may lower cross-listed firms' incentives to hedge, particularly for firms located in English legal origin countries with stronger country-level governance.

***Keyword**: Compensation; Hedging; Sarbanes-Oxley Act*

1. INTRODUCTION

The Sarbanes-Oxley Act (hereafter, SOX), enacted 2002, was an intense effort on the part of U.S. Congress to restore investor confidence in the U.S. capital market in the wake of corporate scandals. This law modifies reporting, disclosure, and governance rules for public companies to promise improvements in the reliability and accuracy of corporate disclosures. In general, the amended U.S. securities laws do not distinguish between U.S. and foreign issuers.

Furthermore, the Securities and Exchange Commission (SEC) adopt new compensation disclosure guidelines on July 26, 2006. Beginning with 2007 filings, US corporations must include a Compensation Disclosure and Analysis (CD&A) section to explain executive compensation and the philosophy that underlies compensation. The primary goal of the CD&A is to provide investors complete and transparent executive compensation structure and the "whys" behind compensation decisions and designs. The new rule represents the broadest and most comprehensive amendments to a public company's disclosure obligations since the adoption of the Sarbanes-Oxley Act of 2002. However, the compliance rates for CD&A guidelines were substantially lower than the nearly 100% compliance rates of SOX (Dalton and Dalton, 2008).

As often happens, the additional liability on executives that may be imposed by aforementioned rules can lead to adverse reactions such as altering management's compensation structure or management's hedging decision that ultimately result in higher agency costs. Prior papers examined the rationale for change of compensation structure and risk-taking behavior following the implementation of the SOX mainly focus on the U.S. firms. Thus far there has been very limited research on the cross-listing foreign firms.

Given the costs of compliance and avoidance, investors expected SOX to have a net negative effect on cross-listed foreign issuers subject to SOX which applies to level 2 or level 3 cross-listed firms, but not to others. Litvak (2007) find that market value of cross-listed firms subject to SOX decrease significantly, compared to non-cross-listed firms and cross-listed firms not subject to SOX. In terms of compliance costs, Litvak (2007) documents that faster-growing companies located in poorly governed countries suffer smaller costs, while low-growth and high-disclosing companies suffering larger net costs, which is consistent with the view that SOX improving investor protection, however, such improvements destroying firm value.