

Discussion of A Lobbying Approach to Evaluating the Sarbanes-Oxley Act of 2002

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OK, you've convinced me. Now go out there and bring pressure on me.

—President Franklin Delano Roosevelt

1. Introduction

President Roosevelt allegedly issued this quip after having engaged in a lengthy exchange with a visiting business delegation. While the story (true or not) may be apocryphal, it illuminates a fundamental confusion that surrounds lobbying: What is it? How does it work? When is it used? And why do we need it? Some believe that the legislative process in this and many other countries could not function without it.

In a fascinating study of lobbying activity during and following the passage of the Sarbanes-Oxley Act of 2002 (SOX), Hochberg, Sapienza, and Vissing-Jørgensen [2009] (henceforth, HSVJ) uncover noteworthy patterns in the behavior of investors and corporate insiders toward influencing the rules to be implemented under SOX by the Securities and Exchange Commission (SEC). They collect 2,689 letters submitted by corporations, investors, lawyers, and academics to the SEC over a three-year period concerning various facets of financial disclosure, corporate responsibility, and auditor

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independence. Among the 379 firms whose insiders lobby the SEC, most do so by arguing against the rules they comment on. Those particular firms also tend to be characterized by agency problems. The authors further design an experiment to exploit these findings on lobbying tendency by evaluating whether the returns to shareholders over this period of analysis are measurably different for those firms that lobby against SOX relative to those that do not lobby at all. Indeed, they find that shareholders of these lobbying firms are rewarded with an economically large 7% cumulative abnormal return over this period, which they interpret as evidence that SOX provides a *net benefit* by improving transparency and governance and by reducing misconduct and mismanagement by insiders. Concerns over compliance costs do not seem to matter.

The study is timely and relevant not only because of the growing interest in the economic consequences of regulatory changes in corporate transparency, disclosure, and governance, like those effected around SOX, but also because of the burgeoning scholarly research on corporate political activity. The findings are surprising relative to the verdict rendered by most existing research on the impact of SOX. HSVJ's clinical study of comment letters written to the SEC around SOX also informs current research on the antecedents and consequences of various types of lobbying behavior. The authors design a clever methodology, execute their analysis in a careful and exhaustive manner, and write it in an approachable and easily understandable way.

In this discussion, I summarize the main contributions and findings of HSVJ, offer a synopsis of the conference discussion of the paper, as well as provide some broader perspectives on the two main lines of inquiry to which the paper contributes.

2. *Contributions and Main Findings of HSVJ*

There are two competing views on the impact of SOX on shareholders. Proponents argue that it leads to improved disclosure, transparency, and corporate governance by constraining corporate managers from consuming perquisites and by dissuading dominant controlling shareholders from extracting private benefits. Opponents believe that SOX is ineffective in affecting the behavior of corporate insiders and that it simply imposes unduly large compliance costs. The central challenge in distinguishing between the views is the lack of a control group of publicly traded firms unaffected by the legislation. HSVJ finesse this problem by exploiting an institutional feature of the process by which the legislation is promulgated into rules through the SEC; specifically, they identify and classify firms that choose to comment on the separate rules proposed by the SEC according to which rules they address in their letters and what they say. All of this information is publicly available on the SEC Web site. It is their clever identification strategy of a benchmarking instrument (the act of lobbying) that represents the main methodological contribution of this paper.

The main findings can be summarized as follows:

- 1) Lobbying firms with corporate insiders that oppose strict implementation of SOX are larger, are more profitable, have lower future growth opportunities, and retain more cash, all characteristics of free cash flow or agency problems. There are no differences in the level of or changes in their audit fees relative to peer firms that chose not to lobby.
- 2) Lobbying firms with corporate insiders that oppose strict implementation of SOX experience higher cumulative abnormal returns during the SOX passage period relative to peer firms that choose not to lobby. These cumulative returns do not reverse themselves following the passage of SOX.

Both results are interpreted as favoring the positive view of SOX's impact on corporate transparency and governance.

Key empirical design choices of HSVJ's study that govern the integrity of the experiment are basically fourfold:

- 1) Identification of lobbyists. The authors assume that lobbying firms are more likely to be firms affected by the passage of SOX. They identify separately individuals, investor groups, noninvestor groups, accountants, lawyers, academics, and corporations that issue comment letters only during the three-year period following SOX's passage in Congress (July 25, 2002 through 2004). They choose to focus on rules related to only the four (of 11 possible) titles of SOX most relevant for public company compliance. Letters are classified as positive, mixed, or negative, and HSVJ narrow their analysis to corporate lobbyists and only those with negative views of SOX.
- 2) Matched sample of nonlobbyers. The 288 lobbying firms are matched to peer nonlobbying firms using a propensity-score ("p-score") matching algorithm including covariates based on size, book-to-market, and industry characteristics (Fama–French 39 industry groups). Peer groups (for the construction of benchmark portfolio returns) are computed using 20 different groupings sorted by p-score index.
- 3) Agency problems. HSVJ follow Jensen's [1986] recommendation that firms with free cash-flow problems are larger (proxied by market capitalization), are more profitable (after-tax operating income to sales), have lower future growth opportunities (firm age, analysts' long-term earnings growth forecasts), and have poorer governance (Gompers, Ishii, and Metrick [2003] governance index). These proxies are computed as of fiscal year 2001 just before the period of study.
- 4) Returns measurement. HSVJ compute portfolio- and firm-level returns differences between lobbyist firms and p-score-matched non-lobbyer peers over the 24-week period pre-SOX passage (February

through July, 2002) and over the 151-week period post-SOX passage (July 2002 through 2004). The returns differences are also adjusted using the Fama–French three-factor model (Fama and French [1993]).

3. *Conference Discussion*

The conference discussion focused almost exclusively on two of the main design features: the identification of lobbyists and the measurement of agency problems.

Audience members challenged the authors on their interpretations that lobbying firms are those most affected by the SOX legislation and rules. There was considerable discussion about the process of writing comment letters, the perceived benefits and the direct costs of doing so, and whether these features overstate the number of firms affected (due to low direct costs) or understate it (due to low perceived benefits of lobbying). Participants wondered whether all letters have equal impact, whether there is significant commonality in the content of different letters across firms, and about the process the SEC staff members adopt in dealing with different letters toward rule making. There were numerous concerns expressed about the extent to which lobbying by any given firm was “abnormal” in regards to SOX compared to that for prior rules adopted by the SEC.

There was also extensive discussion about the reliability of proxies measuring agency problems among corporate lobbyists. In the presentation version, proxies included firm size, profitability, future growth opportunities, cash retention, and payouts. Participants also wondered about timing issues: How would inferences change if governance mechanisms improve or agency problems decline during the period of SOX passage? The authors were responsive in the revisions and incorporated additional measures of governance quality using the Gompers, Ishii, and Metrick [2003] governance index and the level of incentive-based executive compensation and checked on the level of earnings management, the propensity to have had internal control weaknesses or previous accounting scandals.

4. *Some Broader Perspectives*

4.1 PERSPECTIVES ON THE IMPACT OF SOX

The primary motivation for and the major contribution of HSVJ’s study is their innovative use of lobbying as an instrument to benchmark the impact of SOX. An effective instrument eludes most previous studies lacking a proper control group of firms unaffected by the legislation. The evidence on the benefits and costs of SOX are mixed in these studies. How much better is HSVJ’s approach? How reliable is the conclusion that SOX provides a positive (relative) benefit to the firms most affected by the legislation?

The evidence to date on the benefits and costs of SOX basically comes in two types. The first type focuses on what I call *price* effects of SOX, mostly

by examining stock price reactions to key legislative events related to the passage and implementation of SOX. The second type considers *quantity* effects of SOX, mostly by evaluating firm behavior, such as the decision to remain listed or registered with the Securities Act of 1933 and Securities Exchange Act of 1934.

Some price-effect studies examine U.S. exchange-listed firms as those are most logically affected by SOX (e.g., Zhang [2007], Rezaee and Jain [2006], Li, Pincus, and Rego [2008], Chhaochharia and Grinstein [2007]), while others consider foreign firms listed on major U.S. exchanges (e.g., Berger, Li, and Wong [2006], Litvak [2007], Li [2007], Smith [2007]). (These studies are actually conceived around the same time with much crossfertilization of ideas among them, so my simple categorization is hardly perfect.) The latter represents a clever benchmarking innovation as those focusing on U.S. firms have no natural benchmark. While U.S. firms trading on the over-the-counter (OTC) markets or Pink Sheets might be good benchmark candidates as they are not subject to SEC disclosure regulation, they are also typically less liquid and fairly small so not natural comparables. Foreign firms listed on U.S. exchanges, on the other hand, yield a natural experiment as they are affected by SOX (though unintentionally, as Berger, Li, and Wong [2006] point out) and there are comparable, domestically listed firms in their respective home countries that can serve as a natural comparable.

Benchmarking issues are also problematic for studies of the quantity effect of SOX. Two competing studies by Leuz, Triantis, and Wang [2008] and Marosi and Massoud [2007] uncover a significant increase in the number of U.S. firms that go “dark” by deregistering from the SEC reporting obligations and delisting from the major exchanges in the aftermath of SOX. Both studies show that the firms that choose to do so have fewer valuable growth opportunities, are more distressed with weaker governance, and experience larger negative returns on announcement than their peers; the challenge is to identify convincingly a change in the activity and the shareholder reactions that can be ascribed to SOX. A similar problem is obtained for going-private decisions (Engel, Hayes, and Wang [2007]), an activity that increased during the past decade in the United States and in other countries around the world (Leuz [2007] makes a convincing case that the link between SOX and going-dark or going-private decisions is tenuous). To alleviate (but not resolve) benchmarking problems, other researchers focus on the impact of SOX on listing, delisting, and deregistration activity among foreign firms listed on U.S. exchanges relative to equivalent domestic peers unaffected by the legislation (Chaplinsky and Ramchand [2007], Witmer [2006], Duarte et al. [2007], Hostak et al. [2007], Doidge, Karolyi, and Stulz [2008a], Marosi and Massoud [2008], Piotroski and Srinivasan [2008]). Almost all of these studies demonstrate that foreign listing activity has slowed and foreign delisting and deregistration activity has increased, but there is no consensus at all on how much influence SOX has had.

Part of the challenge is that it is difficult to measure the counterfactual of which foreign firms would list in the absence of SOX. Further, the pre-existing rules guiding deregistration, for foreign firms in particular, are so prohibitively difficult (less than 300 registered U.S. shareholders of record needed) that it is difficult to know just how many foreign-listed firms would deregister in the aftermath of SOX had the procedures to do so been easier. Two recent studies devise a unique experiment using an SEC rule change in March of 2007 (new Exchange Act Rule 12h-6) that eases the deregistration requirements specifically for foreign private issuers (Fernandes, Lel, and Miller [2008], Doidge, Karolyi, and Stulz [2008b]). One of these studies (Doidge, Karolyi, and Stulz [2008b]) exploits the benefit of hindsight examining whether those firms that choose to deregister under the new rule are, in fact, unduly harmed (share price reactions) during the earlier period around SOX passage. They are not, which leads them to conclude that SOX likely does not drive these firms away; rather, slowed growth and poor recent capital market experience do.

HSVJ is positioned best to make a contribution in the set of SOX studies on price effects, because of the remarkable sensitivity of inferences about SOX in those studies to different benchmark approaches. Zhang [2007], for example, finds cumulative U.S. market declines of -15.4% across major SOX-related news events, but these translate into economically modest declines between -4.5% and -8.2% , if benchmarked relative to cumulative returns in major international markets. While Rezaee and Jain [2006] and Li, Pincus, and Rego [2008] find large *positive* U.S. market returns during this same period of analysis, it turns out that different SOX-related news events and other methodology issues may be at work (see, e.g., Leuz [2007] and Zhang's [2007] appendix A for details). Consider, also, Berger, Li, and Wong [2006], Li [2007], Litvak [2007], and Smith [2007], who examine the abnormal stock-price reactions of foreign firms listed on U.S. exchanges to the announcements of the passage of key provisions of SOX. Litvak [2007] concludes that there is a significant *negative* reaction to SOX events for exchange-listed foreign firms when measured relative to foreign firms not listed in the United States and to foreign firms listed in the United States via Rule 144a private placements and level 1 (OTC) American Depository Receipts as benchmarks. Berger, Li, and Wong [2006] look at similar SOX-related events but use a value-weighted portfolio of U.S. stocks as a benchmark and find a *positive* reaction for foreign exchange-listed stocks. Both Li [2007] and Smith [2007] uncover significant *negative* abnormal returns for foreign-listed firms when measured relative to home-market index returns as benchmarks. Benchmarking strategy really matters.

HSVJ and their close companion study, Chhaochharia and Grinstein [2007], offer the most innovative identification strategies among these price-effect studies. Rather than using lobbying activities around SOX, Chhaochharia and Grinstein [2007] separate firms that are *ex ante* less compliant with SOX rules (on insider trading provisions, reporting provisions, related-party transactions, internal controls, and board and committee

independence provisions) to show that these firms experience positive shareholder returns around SOX-related events. Of course, the limitation of such papers, which both sets of authors readily acknowledge, is that the conclusions can at most be about the *relative*, and not *absolute* (social welfare), impact of SOX, which is necessarily less useful for policymakers.

4.2 PERSPECTIVES ON LOBBYING

For HSVJ's identification strategy to be powerful, it must be the case that firms that are most likely to be affected by the SOX legislation are those in which insiders lobby against its implementation. Moreover, the market needs to have been able to profile such firms on an *ex ante* basis using various firm characteristics or behaviors. To this end, the authors work very hard to convince the readers that there are many common characteristics that predict lobbying by insiders, such as agency-cost attributes (high cash flows from assets in place, low growth opportunities, weak governance, less incentive-based executive compensation). HSVJ even study a firm's previous lobbying activity around pre-SOX reforms and even their past involvement in scandals, like class-action lawsuits that are not dismissed. But, are lobbying firms likely to be the most affected by legislation? Are propensities to lobby, in fact, predictable by market participants?

Lobbying is difficult to define well. In the Federal Regulation of Lobbying Act of 1946, the U.S. Congress defines a lobbyist as any person "who by himself, or through any agent or employee or other persons in any manner whatsoever, directly or indirectly, solicits, collects or receives money or any other thing of value to be used principally . . . to influence, directly or indirectly, the passage or defeat of any legislation by the Congress of the United States" (U.S. Congress [1946]). While thorough, what is missing in this purely legalistic definition of lobbying is a clear understanding of incentives, which is central to its usefulness for HSVJ's purposes.

Economists have formed a clearer picture of lobbying and what it represents. A much cited study by Grossman and Helpman [1994] (hereafter, GH) presents a special-interest model of trade protection that involves many lobbyists and one policymaker. The fundamental idea behind their model is now a well-established one: Specific factors in an industry combine to form a lobby with the intention of maximizing rents from protection (net of lobbying expenditures). What is innovative in GH's model is that it makes explicit a mechanism through which lobbying activity is converted into protection and lobbyists solve their optimal lobbying spending problem. In other words, protection is endogenous. The GH framework has been adopted in the analysis of the formation of trade blocs and of trade bargaining. Financial economists exploit GH's logic to explain why limited financial development may be the result of political influence to reduce competition to protect incumbents (Rajan and Zingales [2003], Perotti and Volpin [2008]). GH's logic works for HSVJ as it suggests clearly that those lobbying to change legislation are likely those most affected by it.

While this logic has emerged as conventional wisdom, there is an extensive literature in economics predating GH and now emerging in other fields of business that suggests that the motives for lobbying are more complex. For example, Mancur Olson (Olson [1965, p. 2]) discusses “the logic of collective action” and especially the difficulties associated with overcoming free-rider problems. He states: “The widespread view . . . that groups tend to further their interests is accordingly unjustified at least when it is based, as it usually is, on the (sometimes implicit) assumption that groups act in their self-interest because individuals do.” He shows paradoxical instances where either altruistic or even irrational individuals may sometimes end up acting in their group’s interests and provides many empirical examples (in his chapter VI) of groups failing to act in their common interests due to free-rider problems. (While GH acknowledge Olson’s [1965] claim, they simply assume that affected parties are always able to organize themselves into lobby groups.) These Olson-like “failures of collective action” are, of course, consistent with, but still different from, concerns about lobbying motives that stem from the low costs of SEC lobbying activity on which many conference participants focused. So, then, we wonder: Is it that lobbying firms choose to do so because they are most affected? Or, do they do so in spite of their collective best interests, or simply because they are organized to make it easy and low cost to do?

Scholarly research in the area of corporate political activity, defined as corporate attempts to shape government policy in ways favorable to the firm, has seen great strides in the management literature. Hillman, Keim, and Schuler [2004] (hereafter, HKS) offer a comprehensive review of over 120 studies. HKS outline research on the antecedents of corporate lobbying activity that stems from not only firm-specific factors like size, age, financial resources, and firm dependency on government (e.g., amount of defense contracts), which capture capability as well as incentive to lobby, but also industry-specific, issue-specific, and institutional factors that shape lobbying activity overall. Intraindustry dynamics (competitiveness) can play a role but, more importantly, competition can vary across issue characteristics and participants. HKS cite studies that demonstrate how different outcomes arise when firms change venues for their political action across legislative, executive, or judicial branches of government in face of political competition, or countermobilization, from other groups (e.g., business versus antibusiness or union groups). Institutional differences can matter; some crosscountry studies of lobbying show how a country’s degree of pluralism affects the level of lobbying activity in a given country for multinationals (Hillman [2003]). HKS also identify different types of lobbying activity. Proactive “buffering” or “policy-shaping” behavior includes informing government decisionmakers about the impact of possible legislation, but this differs from reactive “bridging” behavior, which tracks legislation in order to have compliance in place when legislation is passed. Some lobbyists employ what HKS refer to as “relational” approaches that are long term and span across issues, while others use “transactional” approaches that are issue specific, and these choices

matter to outcomes. HKS cite research that identifies the different levels of effectiveness of “leaders” and “followers” among corporate lobbyists.

HSVJ take their cue from the study by Lo [2003], which examines the economic consequences of the 1992 revision of executive compensation disclosure rules using a lobbying approach. Lo [2003] finds in support of the value of increased disclosure that corporations whose insiders lobby the SEC against the proposed regulation have positive excess stock returns of about 6% over the period from the SEC’s announcement of the proposed rule and the ultimate adoption of the rule. There are some differences between HSVJ and Lo [2003]: The former examines lobbying by investors, lawyers, academics as well as corporate insiders, but the latter interestingly evaluates the *intensity* of lobbying activity according to the objections of up to eight different proposals for disclosure of executive compensation. This measure of intensity is easily implementable in HSVJ’s SOX study across different elements of the legislation and across the dozen or so SEC rule proposals. More broadly, neither Lo [2003] nor HSVJ consider many aspects of the corporate lobbying landscape that the management research agenda examines, including intraindustry and political dynamics across firms and among lobbying agents, the salience of different issues, the different strategies that are likely employed across SEC proposed rules, as well as strategies around the characteristics of the SEC’s organizational structure and the various departments of the SEC involved in rule making.

So, with this broader perspective, the answer is that, for the most part, lobbying propensity is predictable and those that do so are most likely to be affected by the legislation. There is, however, potential for much richer study of lobbying behavior around SOX.

5. Concluding Remarks and Directions for Future Research

HSVJ’s study of lobbying activity by corporate insiders around the rule implementation phase of SOX deserves significant praise for taking on an important and timely issue. Designing an experiment that uses lobbying as an instrument to benchmark the impact of SOX on these firms is innovative. The analysis is carefully executed, the results are fairly interpreted, and the paper is well written. We learn that cumulative returns to shareholders of firms whose insiders lobby against the SOX provisions are statistically and economically large and positive. The finding challenges much prevailing wisdom about the negative consequences of SOX and, as such, I believe, it offers important new evidence that contributes to the current debate.

My discussion, however, takes HSVJ’s solid study as a departure point for new research initiatives. We learn that some caution must be exercised in interpreting the actions of corporate lobbyists and what their intentions really are. There is much potential in the study of not only firm-level factors, but also industry-specific, issue-specific, and institutional factors that influence corporate lobbying activity. This, in turn, will facilitate better understanding of regulatory/policy outcomes and their broader economic impact.

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