

Corporate Scandals and Household Stock Market Participation

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Corporate scandals have large negative effects on the value of the firms that are discovered

equity holdings (Wang, Winton and Yu, 2010). To establish a causal effect of corporate scandals on local households' stock market participation, we use two different strategies.

The first strategy utilizes an exogenous shock to fraud detection due to the sudden demise of the large auditing firm, Arthur Andersen, in 2002. All Arthur Andersen's clients were forced to change auditors. Since new auditors have incentives to "clean the house", the firms that switched auditor due to Arthur Andersen's demise had higher probability to be revealed as having committed fraud (Dyck, Morse and Zingales, 2013). This led to an exogenous increase in the probability of fraud revelation that differs across states, depending on the fraction of firms in the state that were Arthur Andersen's clients right before its demise. We thus use the

Importantly, fraud revelation in the state leads to a decrease in the number of retail shareholders and a (temporary) decrease in the valuation of firms that have not been revealed having committed fraud, but are headquartered in the same state as the firms committing fraud. Consistent with a negative demand effect caused by corporate fraud, we find that the decrease in valuation is more pronounced for firms with less geographically dispersed activities and less ex ante institutional ownership, which may have to offer higher returns to attract other shareholders replacing local households. We further show that following fraud revelation in the state, non-fraudulent firms tend to repurchase their shares and that local mutual funds tend to increase their holdings in these firms. Thus, our results are unlikely to be driven by an increase in the probability that other firms in the state have committed fraud or by changes in state economic conditions.