# Negation of Sanctions: The Personal Effect of Political Contributions*

**Sarah Fulmer**
Department of Finance
University of Tampa
sfulmer@ut.edu

**April Knill**
Department of Finance, College of Business
Florida State University
aknill@cob.fsu.edu

**Xiaoyun Yu**
Department of Finance, Kelley School of Business
Indiana University
xiyu@indiana.edu

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**Abstract**

We show that political contributions negatively affect the severity of governmental enforcement outcomes for executives accused of committing fraud. Contributing executives receive smaller monetary fines, are banned fewer years as an officer or director of a public company, serve less time in prison or on probation, and enjoy a lower probability of receiving the harshest penalty from both the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ). When exploring potential channels, we find that political contributions lengthen the case time-to-resolution with the SEC and increase the chance of settling with government agencies instead of going to court, allowing fraudulent executives to receive less harsh sanctions. We provide evidence suggesting that executives are able to shift some of the penalty for the fraud on to the firm. Our findings highlight the personal benefits that executives can extract from political connections, and identify a mechanism that potentially undermines the disciplining effect for fraudulent managers.

JEL classification: G3; K4
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## 1. Introduction

On November 27, 2006, Sanjay Kumar, former CEO of Computer Associates, was sentenced to 12 years in prison and 3 years of probation for his role in an accounting fraud of approximately $3.3 billion at Computer Associates spanning the period of 1998-2000. Kumar later also agreed to pay $798.6 million in restitution. Computer Associates had made no political contributions during the period of the fraud.

Approximately five months later, Joseph Nacchio, former CEO of Qwest Communications, was convicted in April 2007 of accounting fraud in connection with the Denver-based company's 1999-2001 $3.57 billion accounting scandal. Nacchio was sentenced to 6 years in prison, ordered to pay $63.4 million in fines and restitution. During the fraud period, Qwest's Political Act Committee (PAC) contributed an average of $119,200 each year. Nacchio himself also made substantial individual contributions.[1]

The existing literature has documented the real effects of political contributions at the firm level. However, we know little about how individuals can be affected by political connections. Yet the above anecdotes highlight that the impact of political contributions may go beyond firms, extending even to corporate executives. In this paper, we focus on the personal side of political contributions, investigating to what extent executives' political connections, initiated and sustained through their companies' and their own political contributions, affect the severity of government penalties when they are charged with fraud.

We collect information on political contributions and manually assemble a novel data on penalties imposed by government agencies for executives accused of engaging in fraudulent activities. We explore two dimensions of government sanctions: civil penalties imposed by the

[1] For details, see SEC Litigation Release No. 20082 (April 19, 2007) and No. 21825 (January 25, 2011) respectively. Information on political contributions comes from the Federal Election Commission.

Securities and Exchange Commission (SEC) in terms of monetary fines and officer bans, and criminal penalties imposed by the Department of Justice (DOJ) in terms of probation and prison sentences.

We document a negative relationship between political contributions and the severity of government enforcement. A $10,000 increase in annual political contributions made by a fraudulent executive, individually and via his firm's political campaign contributions, is associated with a $38,416 reduction in monetary penalty and 0.16 fewer years in an officer ban. Given that an average fraudulent executive in our sample earns $7,466,232 per year, being banned for 0.16 fewer years translates into a saving of over $1.2 million from lost compensation. Each additional $10,000 contribution also leads to 0.341 fewer years of probation, 0.314 fewer years of prison, as well as a 24.9% reduction in the probability that he will receive both an officer ban and prison time—the harshest penalties from both government agencies.

While the baseline results are consistent with the idea that fraudulent executives who make more political contributions face less severe penalties from government agencies, an important concern is that the decision to contribute is endogenous. As such, unobserved factors correlated with both the extent of political contributions and the severity of government sanctions may bias the results. We perform a series of tests to mitigate concerns about endogeneity. First, our results are robust to controls for fraud type-, settlement year-, and industry-fixed effects, as well as to alternative sample restrictions, alternative proxies for political contributions, alternative disciplinary measures, and alternative econometric models.

Second, we construct instrumental variables (IVs) for the amount of political contributions and undertake a two-stage least squares (2SLS) analysis. The 2SLS analysis continues to suggest a negative effect of political contributions on the severity of both civil and

criminal penalties. In addition to the IV approach, our results are invariant if we address the potential endogeneity in political contributions using a two-step Heckman procedure or the Abadie-Imbens (2006) matching framework.

Third, we show that the disparities in government penalties between fraudulent executives who make generous contributions and those who do not are not likely driven by alternative economic causes such as "benefit exceeding harm", "earned leniency", and "alternative disciplining mechanisms". Specifically, the "benefit exceeding harm" hypothesis postulates that when assessing the penalties, the SEC and/or DOJ may take the net effect of the work of an accused executive into consideration if he has otherwise managed the firm well and increased shareholder wealth. The "earned leniency" argument suggests that if a firm has generally exercised good governance and put its best efforts forth to comply with SEC regulations, this compliance may earn that firm (as well as its executives) leniency for any wrongdoing. The "alternative disciplining mechanisms" hypothesis takes into account the fact that there exist many types of potential penalties for misconducts, all of which are substitutes or complements to unknown extents. For instance, the SEC is known to (implicitly) coordinate its penalties with the results of private lawsuits. Thus, this hypothesis proposes that a government agency may impose less severe penalties where the accused executive has already been penalized by the firm or the market.

We find that the impact of political contributions on reduced government sanctions remains statistically and economically significant after controlling for these alternative hypotheses and discipline mechanisms. Thus, the net benefits accrued to shareholders, earned leniency, and alternative sanctions (termination by the board, class action lawsuits, and firm

delisting) do not fully explain the results. Overall, these tests corroborate the causal interpretation of our findings.

In the last step of our analysis, we explore two channels through which political contributions can potentially generate reduced government sanctions for fraudulent executives. We collect data on how the cases are resolved and distinguish between cases that result in a court judgment and those that are resolved through a settlement with the SEC and/or a plea bargain with the DOJ. Penalties determined by courts are usually significantly harsher. For instance, executives in our sample face $8.85 million more in monetary penalty and 3.28 more years in prison if penalties are imposed by the court. *Ceteris paribus*, they would prefer that the penalties be imposed by government agencies rather than by the court. Indeed, we find that political contributions allow fraudulent executives to receive more lenient sanctions by settling with the SEC and/or reaching a plea bargain with the DOJ, instead of going to court.

Katz (2010) points out that within the SEC, enforcement actions that take longer to resolve are often closed with no resulting penalties, particularly when a new attorney is assigned the case or a new SEC Commissioner is appointed. This implies that if a fraudulent executive can delay resolution of the case long enough, he could potentially also reduce the severity of the penalty imposed by the SEC. We find that political contributions help lengthen the case time-to-resolution, allowing for less severe civil penalties.

Finally, we provide evidence that political contributions facilitate transfer of penalty from fraudulent managers to shareholders. As the severity of government sanctions on individual executives declines, penalty accrued to the firm that suffers from their fraudulent activities, measured by the amount of fine imposed by the SEC, increases. More importantly, the extent of

shifting the fraud consequence to shareholders is exacerbated in the presence of more aggressive political contributions.

Our paper contributes to the large literature studying the real impacts of political connections and contributions. On the one hand, researchers have found that political contributions and connections benefit shareholders in a variety of countries in terms of higher market values (e.g., Fisman 2001; Faccio 2006; Jayachandran 2006; Claessens, Feijen and Laeven 2008; Cooper, Gulen and Ovtchinnikov 2010), more government contracts (Goldman, Rocholl and So 2013), and a higher likelihood of government bailouts (Faccio, Masulis and McConnell 2006). On the other hand, political connections can entail social costs (Fisman and Wang 2015; Giannetti, Liao, You and Yu 2017) and pose challenges for corporate governance (Dahan, Hadani and Schuler 2013). In particular, political spending allows firms to deter fraud detection (Yu and Yu 2011) and reduces the probability that the firm is involved in SEC enforcement and the monetary penalties it received from the SEC (Correia 2014).

Most of the above literature focuses on how political contributions benefit or harm the *firm*. By contrast, we focus on the *personal* aspect of political contributions. To the best of our knowledge, ours is the first empirical paper to highlight how executives may use political connections for personal benefit. Examining penalties at individual executive level allows us to explicitly explore how political spending affects penalty transfer between fraudulent mangers and shareholders. Our paper thus complements Correia (2014) by providing novel evidence that political contributions can skew the enforcement process in ways that benefit managers, allowing executives to shift the consequences of the fraud away from themselves, even if that means shifting the consequences to the shareholders.

In addition, we document the role of political spending on the government enforcement process, above and beyond fraud detection; our findings thus imply that penalties are not optimal and that the effect of political contributions on corporate governance may have been previously under-estimated. In light of Karpoff, Lee and Martin (2008), who show that managers responsible for corporate financial fraud suffer negative career and monetary consequences, we identify a mechanism that can undermine the disciplining effect for fraudulent managers and potentially exacerbate an executive's ex-ante incentive to commit fraud.

Our paper also contributes to the literature in finance on corporate fraud (see Yu 2013 for a survey). A strand of this literature investigates the effectiveness of mechanisms—including government agencies—that are designed to detect fraud (e.g., Dyck, Morse and Zingales 2010; Kedia and Rajgopal 2011; Yu and Yu 2011; Correia 2014). Instead of the efficiency of government agencies in detecting fraud, we focus on how political contributions affect their ability to regulate and discipline (i.e., assess and impose penalty) after the fraud is discovered.

The rest of the paper is organized as follows. Section 2 discusses the research design. Section 3 describes the data and sample characteristics. Sections 4 and 5 present the empirical results. Section 6 concludes. Variable definitions and constructions are in the Appendix.

## 2. Research Design

### 2.1. Institutional Background

#### *2.1.1. Regulatory Restrictions on Campaign Contributions*

Most of the regulations that surround campaign contribution disclosure have their roots in the Federal Election Campaign Act (FECA) of 1971, which requires those running for political office to disclose contributions: both the contributor names and amounts, as well as how the

contribution was spent. The Federal Election Commission (FEC) was created in 1974 and statutory limits on campaign contributions were introduced via an amendment to FECA. This amendment limited the dollar amount of contributions per candidate and per election cycle made by individuals to $1,000 as well as those made by political action committees (PACs) at $5,000.

In 2002, Congress amended the FECA with the Bipartisan Campaign Reform Act of 2002 (BCRA), which limited "soft money" contributions to federal parties and indexed contribution limits for inflation.[2] Under current law candidates are required to identify all person(s) who contribute more than $200 per election cycle. FECA prohibits corporations from making direct political contributions in federal elections. However, a corporation may contribute indirectly either through contributions to PACs or contributions of its officers. Furthermore, PAC contributions are limited in two ways: individuals cannot contribute more than $5,000 to a single PAC in any given year, and PACs may not contribute more than $5,000 to any particular candidate in a given election cycle.

*2.1.2 SEC and DOJ Investigations*

Following a "trigger event" and a formal investigation, the SEC files a complaint against named defendants. The defendants can include the firm, executives, lower-level employees, auditors, partners, and/or outsiders. After an investigation, the SEC either drops the case or continues with administrative, civil, and/or criminal litigation proceedings. In the case of potential criminal behavior, it may be referred to the Department of Justice.

The SEC publicly discloses the Accounting and Auditing Enforcement Releases (AAERs), which are the copies of court documents or summaries of court rulings on actions

[2] BRCA indexed the individual contribution limit for inflation, increasing it from $1,000 to $2,000. See Pub. L. No. 107-155, 116 Stat. 81 (2002), 2 U.S.C. 431. The limit for individual contributions per candidate was further increased to $2,500 for the 2011-2012 election cycle, while the PAC limit has remained at $5,000. See also "FEC Announces 2011-2012 Campaign Cycle Contribution Limits", February 3, 2011, available at http://www.fec.gov/press/press2011/2011Releases.shtml.

instituted against a firm and/or individuals by the SEC, or notices of settlement or court rulings. The documents note, among other things, the date the enforcement action commenced, the period of time in which the fraud occurred, the date of resolution and the type of fraud of which an executive was accused.

When an action is resolved, the AAER lists (a) the monetary penalty, (b) whether the executive was banned from serving as an officer or director at a public company, and if so, the length of the ban, and (c) whether any criminal penalties were imposed by the DOJ. The total monetary penalties consist of civil penalties and fines, disgorgement of illicit profits, and sanctions.

In cases where criminal penalties are mentioned, specifics of resolution are not always mentioned. Since the DOJ has no central repository system analogous to AAER, we use three supplemental methods to determine criminal penalties. First, we cross-reference our list of executives with the Corporate Counsel Fraud Database and Corporate Fraud Task Force Reports. Second, we check to see if we can find any information on the websites of the individual offices of the US Attorneys. Finally, we perform a Lexis-Nexis and Google search for criminal penalties.

**2.2. Measuring the Severity of Government Enforcement**

Once an executive is found liable for fraud, the government can impose civil penalties, criminal penalties, or both. In term of civil penalties, we start with the monetary penalties. "Monetary Penalty" is the natural logarithm of one plus the total dollar amount of monetary penalties imposed on an accused executive.

Alternatively, we scale monetary penalties by the total compensation that the executive receives at the beginning of the fraudulent period. The total compensation is the sum of the executive's salary, bonus, other annual, total value of restricted stock granted, total value of

stock options granted (computed using Black-Scholes), long-term incentive payouts, and all other total. Not only does executive compensation affect the severity of fraud (Peng and Roell 2014), but more importantly, the variable "Monetary Penalty/Compensation" captures the degree of monetary damage to a fraudulent executive's personal wealth. In many ways this measure is more relevant to the severity of the penalty, as one would expect that a $100,000 monetary penalty, which is approximately the median monetary penalty in our base sample, would be felt less by a CEO earning $6 million per year than a Vice President earning $250,000 per year. More importantly, since political contributions lead to higher firm value (Fisman 2001; Faccio 2006), the amount of monetary penalty may be marginal or negligible if the wealth of the accused executive has increased dramatically during the fraudulent period.

The second aspect of a civil penalty is the severity of an officer ban. Being banned as an officer prevents an individual from serving in a top managerial role, representing a significant economic penalty in the form of reduced lifetime earnings. The longer the ban period, the greater the potential compensation loss accrued to an individual. We compute "Officer Ban" as the natural logarithm of one plus the number of years the fraudulent executive is banned as an officer or director of a publicly listed company. This variable is set to zero if no officer ban is imposed. In cases where an executive receives a permanent officer ban, we determine the effective length of the ban by estimating the number of the years the executive could have served as an officer, had the ban not been imposed. Specifically, the length of the effective ban is computed as the difference between retirement age and the executive's age at the time the permanent ban was imposed.[3]

[3] In our main analysis, we use 78 as the cut-off for retirement age. Some, but not all, of firms may have mandatory retirement ages ranging from 72 to 75 for directors. Results are robust if we use 72 or 75 to calculate the length of the effective ban.

In terms of criminal penalties, an accused executive can receive probation and/or a prison sentence. We compute "Probation" as the natural logarithm of one plus the number of years (or fraction thereof) of probation the executive received, and "Prison" as the natural logarithm of one plus the number of years (or fraction thereof) of prison time the executive received. These variables are set to zero when no probation or prison term is involved. Note that an individual may receive probation instead prison, or receive a prison sentence only. In some cases, an accused executive receives both probation and prison terms. For this reason, we examine probation and prison separately in our main analysis. In Section 5.2, we estimate the overall severity of penalty, taking into account probation as a potential substitute sentence for prison.

Lastly, we capture the probability of receiving the most severe degree of penalty that can be imposed criminally and civilly with "Prison & Ban". This dummy variable equals to one if an accused executive receives both the most severe civil penalty from the SEC and the most severe criminal penalty from the DOJ, and zero otherwise.

### 2.3. Measuring Political Contributions

The primary goal of the paper is to identify and assess the overall impact of an executive's political connection on government enforcement. In reality, however, an executive can channel contributions to a politician via his firm's PACs, as well as contribute directly as an individual. Our key independent variable, "Political Contributions", is thus defined as the average annual contribution (in $10,000s) made by an accused executive and his firm (via PAC) during the period of the fraud. This variable is set to zero for those that do not contribute. To account for the skewness of the amount of political contributions, we take the log transformation of this value.

By aggregating all the available contribution channels, this variable allows us to better capture the *cumulative* effect of corporate executives spending on building and maintaining political connections. This is because, while personal contributions may suggest a more aggressive and clear preference of the contributor, it is limited by a lower cap compared to a firm's PACs thus may understate the contribution effort. By contrast, PACs not only allow an executive to shift the cost of spending on political contributions to shareholders, but also offer the anonymity for the contributors, which is more relevant to our research question. Furthermore, Babenko, Fedaseyeu and Zhang (2017) provide causal evidence that employees contribute significantly more money to political candidates supported by CEO, suggesting that PAC contributions are potentially an extension of contributions from top management of the firm.

In Section 5, instead of the intensity of political contributions, we extend our analysis to the decision to contribute. The results are robust to this alternative specification.

### 2.4. Identification

The decision to make a political contribution is likely endogenous. In the main analysis, we address the issue of causality using an instrumental variable (IV) framework. In the robustness session (Section 5.3), we also estimate our baseline tests using, respectively, a two-step Heckman model and the Abadie-Imbens (2006) matching approach.

An ideal instrument would be strongly correlated with political contributions but would not directly influence the extent that government agencies impose penalties on fraudulent executives. We construct two instrumental variables for the amount of political contributions. Our first instrument exploits plausibly exogenous variation in political contributions due to the voting behaviors of legislators in alignment with the political orientation of corporate executives. This instrument is motivated by the political science literature documenting that campaign

contributions are highly responsive to legislative candidates' ideologies (Wright 1985; Poole, Romer, and Rosenthal 1987) and voting behaviors (Conley and McCabe 2012). It is built upon the emerging literature using monetary contributions to political campaigns to identify political values of individuals and corporations. For instance, a number of papers argue that politically conservative individuals or institutions contribute to parties that share the same core conservative political ideology (Hong and Kostovetsky 2012; Hutton, Jiang and Kumar 2015; Jiang, Kumar and Law 2016).[4]

Since political conservativeness is partially explained by an individual's income, age, gender, race, education and religion (Campbell et al. 1960; Levitt 1996), contributions by corporate executives and their firms can be correlated with the conservative votes by politicians.

The empirical challenge to identify the conservativeness in the Congressional voting behaviors is that many existing proxies, such as a politician's self-claimed ideologies and party affiliation, can be used to cater political contributions; they also likely affect the leniency of government agencies in assessing the penalties. To ensure the satisfaction of the exclusion restriction, we follow Washington (2008) and extract the conservative leanings in a legislator's voting behavior that stems from his or her offspring gender mix.

By collecting data on the voting records of U.S. congresspersons, Washington (2008) provides persuasive evidence that the congresspersons with female children tend to vote more liberally on a range of issues, such as flexibility for working families and tax-free education, and productive rights. In a broader sample, Oswald and Powdthavee (2010) show that having

[4] There is a large literature documenting the differences between conservative and liberal values. This difference is also reflected in the partisan differences between Democrats and Republicans. A growing strand of literature in finance demonstrates that political preferences of market participants influence their economic decisions (e.g., Hong and Kostovetsky 2012; Di Giuli and Kostovetsky 2014; Hutton, Jiang and Kumar 2015; Jiang, Kumar and Law 2016), and shows that contributions to the Democratic Party reflect contributors' being more aligned with liberal values, and contributors to the Republican Party are more aligned with conservative values.

daughters leads people to be more likely to vote for left-wing politician parties, whereas parenting sons seems to make people more likely to vote for right-wing parties.[5] Compared to other proxies such as a politician's ideology and party affiliation, the appeal of this instrument lies in its random assignment in a country like the United States, where gender selective abortion is nearly nonexistent. Put differently, the gender mix of legislators' offspring is unlikely the factor considered by the SEC or DOJ when assessing penalties on accused executives for their fraud. This rationale ensures that our instrument reasonably satisfies the exclusion condition.

Specifically, our first instrument, "Daughters", captures the extent of liberal leaning in the voting behaviors among local politicians that is aligned (or misaligned) with political ideology of contributing executives from local firms. We calculate this variable by averaging the number of politicians in the state where the fraudulent executives' firm is headquartered that have daughters across the fraudulent period, and scaled by the average number of senate and congressional seats during the same period. By construction, this variable measures the extent of political ideology among local politicians (in this case, the liberal leaning in their voting behaviors) that affects contributions by local firms and individuals.[6] Consequently, it should affect the severity of government sanctions only through its effects on political contributions.

Our second instrument relates to a firm's past political contribution activities. "Prior Contribution" is a dummy variable if the firm has made political contributions 15 years prior to the beginning of the fraud. The intuition is straightforward. Political contributions tend to persist over time (Yu and Yu 2011). While a firm's past political contributions are correlated with its

[5] An emerging literature has leveraged the natural experiment of a child's gender to a broader range of issues such as the effect of parenting daughters on the votes of judges (Glynn and Sen 2015) and on corporate investments that are aligned with liberal value such as corporate social responsibility (Cronqvist and Yu 2016).

[6] While the family structure (i.e., parenting a daughter) is identified at the individual politician's level, the implications of the variable generalize easily to the state level. For example, if liberal (conservative) executives are less likely to contribute to a given conservative (liberal) politicians due to different ideologies, the executives would likewise be less likely to contribute to all conservative (liberal) politicians.

current contributions, they are observed years before any lawsuit and the subsequent government penalties. As such, they are unlikely to directly affect the varying degrees of sanctions imposed on executives that more than likely weren't in their positions many years before the beginning of the fraud (see, e.g., Kaplan and Minton 2008).

## 3. Data and Sample Characteristics

### 3.1. Government Enforcement

Our proxy for detected fraud is the filing of an enforcement action against an executive of a publicly traded company in the United States. We identify executives who were investigated for civil fraud during the period of January 1999 to December 2010 using the SEC's AAERs. An "executive" can be the Chief Executive Officer (CEO), Chief Financial Officer (CFO), Chief Operations Officer (COO), Chief Information Officer (CIO), Chief Accounting Officer (CAO), Director, Controller, Treasurer, President, Vice President, General Counsel, or Chairman of the Board.

We manually screen over 2,000 AAERs for civil actions initiated against executives of publicly-traded companies. Since our sample is at the executive level, we are careful to avoid any duplications across releases. Our initial manual screening yields 572 accused executives from 238 firms. For the purpose of our study, we exclude 69 executives in which the SEC enforcement actions have not been resolved (i.e., settled, dismissed, or resolved by court judgment) by December 31, 2010.[7] We further remove 51 executives that have missing firm-level information in Compustat. Our final sample includes 452 executives from 194 firms. Of

[7] Though all of the civil charges in our sample are resolved, there may be outstanding criminal charges with the DOJ. Criminal charges and penalties are current as of March 6, 2014.

these executives, 79 are CEOs and 144 are CFOs. The remaining 229 observations represent actions against other executive officers.

For these 452 executives, we collect information from the AAERs on the duration of the fraud, the amount of damages caused by fraudulent executives and assessed by the government agencies, the date the action was initially filed, the date the action was finalized, whether the case was settled within the agency or resulted in a court judgment, as well as type of fraud the individual was accused of by the SEC.[8] Earnings restatements are from the Audit Analytic. Note that the AAER period of 1999 to 2010 corresponds to the date in which the actions are commenced or resolved. Since it often takes years to detect fraud (in our sample, the average time to detection is 3.35 years after the fraud is complete) and additional time to reach a final resolution once the fraud has been detected (on average 1.3 years), the period in which executives commit fraud ranges from 1991 to 2007.

We collect information on civil penalties including monetary fines/disgorgement and officer bans from the AAERs. Obtaining data on criminal penalties, on the other hand, is less straightforward. This because the DOJ is comprised of 94 individual districts ("Offices of the United States Attorneys"), each with its own case load. Unlike the AAER database, there is no central database that lists all actions taken by the DOJ. Also unlike the AAERs, which issue a press release whenever the SEC files an action against a firm or an individual, only the most significant financial fraud cases are reported on the individual district websites.

[8] There are six types of fraud identified in the SEC's AAERs: earnings fraud, securities fraud, option backdating, bribery, insider trading, and embezzlement. Earnings fraud includes allegations that the executive materially misstated some relevant performance measure such as revenue, pre-tax income, or net income. Securities fraud includes manipulating stock prices either for personal gain or around a securities offering (IPO, SEO, or debt issuance). Options Backdating includes instances where either the option grant date or the option exercise price were changed retroactively. Bribery includes violations of the Federal Corrupt Practices Act. Executives can be accused of more than one type of fraud.

To avoid the potential selection bias in that only the most publicized cases are reported, we proceed as follows: we start with our sample of executives accused of civil infractions by the SEC and see whether the DOJ also pursued criminal charges against these executives. Since the SEC only has authority to bring civil actions, the AAERs focus on civil penalties. Nevertheless, the AAERs often contain information relating to pending criminal litigation or criminal sanctions against the executive.

We then use two supplemental methods to determine criminal penalties resulting from concurrent or subsequent DOJ enforcement. First, we cross-reference our list of executives with the individual websites of the 94 Offices of the United States Attorneys, the Corporate Counsel Fraud Database, and the Corporate Fraud Task Force Reports. Second, we perform a Lexis-Nexis and Google search for those executives we were unable to find using the methods listed above. We search all executives, whether or not criminal penalties were mentioned in the AAERs, and identify 142 of our executives that were criminally charged by the DOJ. Of these, we were able to obtain the specifics of criminal outcomes for 138 charged executives. Doing so ensures that we have not missed anything from the AAER, if it was not included in the release. An example of this would be if only one type of fraud were mentioned in the AAER when multiple types were involved. Our data collection design has the benefit of double-checking for any omissions of relevant information to our analysis.

### 3.2. Political Contributions

Our data on campaign contributions come from the detailed committee and candidate summary contribution files of the Federal Election Commission (FEC) for the period 1991 to 2007. The data collected by the FEC comprises total campaign financing raised by each candidate's (re)election campaign from different parties. These parties comprise the following

groups: (1) individuals, (2) labor organizations, (3) corporations, (4) trade, membership, and health organizations, (5) party committees, (6) nonparty committees, and (7) corporations without capital stock. By law, PAC contributions to a specific candidate may not exceed $5,000 per election cycle. For individuals who contribute, the limit varies between $1,000 per election cycle, up to $2,500 per election cycle in 2011-2012. For the purpose of campaign contribution limits, the primary election and general election are considered separate election cycles. The contributions in our data are made to any presidential or congressional political campaign. We manually collected PAC contributions beyond 2004 and individual executive contributions for the entire sample term from the Center for Responsive Politics.

**3.3. Politician's Family Structure**

We merge Washington's (2008) data on children's information of the Congressional members between 1997 and 2004 (the 105$^{th}$-108$^{th}$ Congress) with our sample of 2,012 politicians who have received political contributions from executives, either through their firms' PACs or through direct individual contributions. We are able to identify the children and their gender of 585 legislators. For the remaining 1,427 politicians, we manually collect, from the 101$^{st}$ through the 111$^{th}$ Congressional Directory, their children's information, including names and years of birth (if provided).

A legislator's family structure may change during the course of his/her political career, especially if the politician is repeatedly re-elected. For this reason, we track each politician's biographies through the entire 101$^{st}$ through 111$^{th}$ Congressional Directory, whenever available. For a great majority of the cases, only the names or the number of legislators' children are published in the Congressional Directory. In cases where the names of the children are ambiguous with regard to gender, and where only the number of children is provided, we search

Wikipedia, nndb.com, votesmart.org, OpenSecrets.org, and/or Sunlight Foundation online. We also identify children's gender information by searching obituaries, wedding announcements, special-focused interviews and news articles, social media, and family holiday photos. In cases where a child's name still remains ambiguous, we search the following websites for gender based on names: babycenter.com, thinkbabynames.com, and babynameworld.com. We are able to identify children's information of 2,012 politicians.

In cases where the various websites provide contradicting information, we verify by cross-referencing at least another independent web source. Lastly, we manually cross check and update the children's information based on the Washington's (2008) dataset.

### 3.4. Other Data Sources

Firm financial information comes from Compustat. The total compensation of the executive is TDC1 (i.e., the sum of the executive's salary, bonus, other annual, total value of restricted stock granted, total value of stock options granted (using Black-Scholes), long-term incentive payouts, and all other total) from Execucomp, measured at the beginning of the fraudulent period. Since many of the executives in our sample come from smaller (non-S&P 1500) firms, whose compensation is not available at Execucomp, we manually search the proxy statement (DEF 14A) in SEC EDGAR using Execucomp's definition of TDC1. Many of the executives in our sample are not in the five highest compensated executives, and thus their compensation is not required to be disclosed. As a result, we are only able to compute total compensation for 192 of our 452 executives.

### 3.5. Descriptive Statistics

Figure 1, adapted from Karpoff et al. (2008), displays the timeline from the initiation of the fraud to the resolution for our sample. An average fraud lasts for 3.4 years. The SEC

enforcement period on average lasts about 3.35 years, followed by another 1.3 years to reach the final resolution.

Panel A of Table 1 reports the descriptive statistics for fraudulent executives. Twenty-two percent of our sample executives make political contributions. The annual contribution across candidates and election averages $15,406 per year during the fraudulent period. However, among those who contribute, the average annual political contribution is approximately $43,523, which is comparable to that reported in the existing studies (e.g., Ansolabehere, Snyder and Tripathi 2002; Cooper, Gulen and Ovtchinnikov 2010). The assessed total harm to the firm and its shareholders brought by an accused executive averages around $500 million. There is also evidence about the collusion inside the executive suites: on average, 3.68 executives in the same firm of the fraudulent executive were also accused for fraud.

Panel B shows a breakdown of the number of executives by fraud type. Note that an individual may be accused for more than one type of fraud. Earnings fraud is the most common type of fraud; with 91% of the 452 executives accused of manipulating earnings or revenue. The next most frequent fraud is securities fraud, accounting for 16.4% of the accused executives. It is also evident that a great majority of frauds occur within the executive suite.

Panel C reports the types of enforcement outcome that accused executives receive during the sample period. On average, an accused executive is fined $6.04 million, and receives 7.99 years for officer ban, 1.25 year of probation, and 2.02 years in prison. There is also preliminary evidence that penalties vary among the accused executives. For instance, those who made political contributions on average receive 2.77 fewer years of officer ban, 1.43 fewer years of probation, and 1.03 fewer years in prison than non-contributors. They are also less likely to receive the most severe penalty—both officer ban and prison (26.3% of contributors receive the

most severe penalty, compared with 49% of non-contributors). The Wilcoxon rank-sum test suggests that the difference between the contributor and non-contributor subsamples is statistically significant.

## 4. Political Contributions and the Severity of Penalties

### 4.1. Baseline Regressions

We study the link between political contributions and the severity of assessed penalties by estimating the following regression model at the executive level:

$$Penalty = \beta_0 + \beta_1(Political\ Contributions) + \Omega' Z + \delta_F + \delta_E + \delta_I + \delta_Y + \varepsilon$$

where the dependent variable is one of our civil or criminal penalty variables. $\delta_F$, $\delta_E$, $\delta_I$, and $\delta_Y$ are, respectively, fraud type, executive role, industry, and settlement year fixed effects. The key explanatory variable is "Political Contributions". Robust standard errors are clustered around the role of executive.[9]

Our set of control variables ($Z$) contains proxies for fraud-specific, firm-specific, executive-specific and legal-environment-specific characteristics that may affect the extent of enforcement. For instance, the size and severity of the fraud are positively linked to legal and monetary penalties (Karpoff, Lee and Martin 2007). We measure the severity of fraud by "Damages", computed as the natural logarithm of the amount of damages assessed by the SEC.[10]

[9] The role of executives follows the categories listed in Panel B of Table 1: CAO, CEO, CFO, CIO, COO, Chairman, Controller, Director, General Counsel, President, Treasurer, or Vice President. Our results are robust if standard errors are clustered at the firm level.

[10] In the case of earnings fraud or options backdating, the damage is the amount that the firm misreported on its financial statements; in the case of securities fraud, the amount of shareholder loss; in the case of FCPA bribery, the amount of the bribes paid; and in the case of embezzlement or insider trading, the amount of personal gain to the executive. Damages represent the SEC's estimates of the total loss to the firm (or shareholders) as a result of the fraud, which would not depend on whether the fraud was determined to be criminal or civil. In cases where there is more than one type of fraud, the amount is the cumulative effect of the fraud(s). Hence, it is not necessarily a summation of the damages from each fraud type, but rather the net effect of the multiple fraud types (allowing for overlapping damages).

Damages can be more significant when a fraud lasts for a longer period of time (Yu and Yu, 2011), resulting more severe penalties. We thus control for the duration of the fraud, calculated as the number of years from the initiation of the fraud to its conclusion. Finally, we include the number of accused executives in the fraud, as misconduct is more likely and more complex in groups than individually (Kocher, Schudy and Spantig 2017).

There may exist other types of potential penalties for the accused executives. For instance, the SEC may substitute a large penalty on the firm for a smaller penalty on the manager because it believes the firm-level penalties encourage optimal internal monitoring and enforcement.[11] Put differently, the firm itself may be fined by the government for the fraudulent activities conducted by its executives. As a result, an executive might receive a lesser punishment since the shareholders of the firm have already paid a penalty. To capture this potential substitution effect, we include "Firm Fine", which is the natural logarithm of one plus the dollar amount of fine paid by a firm as a result of fraud committed by its executive.

The severity of the penalties that an accused executive receives may also be affected by the nature of the fraud itself. For instance, the SEC might have more authority to impose sanctions for some types of fraud than others, and/or certain natures of fraud are more destructive than others. For this reason, in all regressions we include fraud type dummies.[12]

To account for the possibility that executives working for a larger firm can use its "deep pockets" to fend off charges and pay for civil penalties (Karpoff, Lee and Martin 2007), or that they have access to superior legal counsel (in terms of quality, quantity, or both), we control for

[11] For a discussion on whether it is optimal to have firm-level or manager-level penalties, see, e.g., Arlen (1998).

[12] The fraud type dummies capture the six types of fraud identified in the SEC's AAERs, as well as earnings restatement, which sets to one if a firm issued a formal earnings restatement in connection with the fraud. While there is an overlap between the earnings fraud from the AAERs and the earnings restatement from the Audit Analytic, these two are not identical. Many (but not all) of the investigations for earnings fraud were triggered by the firm's restatement, while some firms issued a restatement as a result of the SEC action. Put differently, not all restatements trigger an SEC investigation, and not all investigations resulted in a restatement.

firm size, calculated as the natural logarithm of the firm's average market cap during the fraudulent period. Following Kedia and Rajgopal (2011), we also include a dummy for small firm to capture the potential non-linear effect of firm size in affecting the extent of government investigation and enforcement; a firm is considered small if its total assets at the beginning of the fraudulent period are less than $200 million.

In terms of individual characteristics, the role of the executive may influence penalties. CEOs or CFOs could be held more responsible than those in other roles. Collusion in the executive suite heightens the risk of corporate fraud (Khanna, Kim and Lu 2015). For instance, in the case of Qwest, in addition to CEO Joseph Naccio, four other executives were incarcerated and six were acquitted. In the case of Computer Associates, seven other executives besides Sanjay Kumar were sanctioned. To take into account that the complexity of fraud and collusion among executives may affect to what extent the SEC/DOJ assess and impose certain penalties on individual officers, we include executive role fixed effects and control for the number of officers from the same firm that are investigated for the same matter.

Lastly, we include various proxies to capture the changes in the regulatory and enforcement environment. For instance, the Sarbanes-Oxley Act of 2002 (SOX) imposed greater criminal penalties for financial fraud, created new types of financial fraud, and increased the personal exposure of top executives to liability for financial misrepresentation. The head of the government agencies (Commissioner for the SEC or Attorney General for the DOJ), which, unlike the Supreme Court, is appointed by incoming presidents,[13] can play a role in determining

[13] The SEC is slightly different than the DOJ in that appointments occur in June and are somewhat more flexible. As stated on the SEC's website, "The Securities and Exchange Commission has five Commissioners who are appointed by the President of the United States with the advice and consent of the Senate. Their terms last five years and are staggered so that one Commissioner's term ends on June 5 of each year. The Chairman and Commissioners may continue to serve approximately 18 months after terms expire if they are not replaced before then. To ensure that the Commission remains non-partisan, no more than three Commissioners may belong to the same political party. The President also designates one of the Commissioners as Chairman, the SEC's top executive."

the severity of the penalties. To illustrate, a government official picked by a Republican president may exhibit a different degree of friendliness towards corporations and leniency when assessing penalties than those selected by a Democratic president.[14] A legislator's influence on the agencies, hence the effectiveness of political contributions to the legislator's campaigns, is affected by whether he or she is a member of the same party as the president who appoints the chiefs of the agencies. A firm's lobbying activities can also affect legislation, allowing for a potential venue to exert influence on the extent of imposed penalties. Therefore, we include a dummy for whether or not the penalty is imposed after July 30, 2002—the enactment of SOX ("SOX"), a dummy for whether or not the case resolution occurred and corresponding penalties were imposed at the time the head of the SEC and/or DOJ was appointed by a Republican Party president ("Republican Appointed Chief"), and a dummy for whether or not a firm engages in lobbying activities ("Lobby"). To further account for the fact that a penalty is affected by time-specific and industry-specific unobserved characteristics, we include, for all regressions, dummies for settlement year, as well as industry dummies.

Columns 1 through 3 of Table 2 present the regression estimates with respect to civil penalties imposed by the SEC. We observe that "Political Contributions" is negatively related to the magnitude of all three proxies for the civil penalties, and is statistically significant at least at the 5% level. Controlling for firm-specific, fraud-specific, and executive characteristics, as well as the legal and regulatory environment at the time when sanctions are imposed, and unobserved industry-, fraud-, executive-, and year-specific factors that may affect the severity of civil penalty, larger political contributions are associated with a reduced monetary penalty and fewer years being banned as an officer or director. These effects are not only statistically, but also economically significant. For instance, column 1 of Table 2 indicates that a $10,000 increase in

[14] "Bush S.E.C. Pick Is Seen as Friend to Corporations", June 3, 2005, The New York Times.

political contributions from the sample mean is associated with a $38,416 reduction in monetary penalty. The same increase is associated with a 0.16 of a year reduction in officer ban (column 3). Based on the sample average of our executive compensation ($7,466,232), this translates into approximately $1.2 million reduction in lost wages.

Columns 4 and 5 of Table 2 represent the results of criminal penalties imposed by the DOJ. In column 6, we estimate a probit model to examine the likelihood when an accused executive receives both the most severe civil penalty—officer ban—and the most severe criminal penalty—prison term.

We observe that the amount of political contributions made by an accused executive is significantly negatively correlated with the number of years of probation and/or prison he receives, and the probability of receiving the most severe sanctions. A $10,000 increase in political contributions from the sample mean is associated with a reduction in prison of close to a third of a year (0.314), which accounts for 17% of the sample mean of prison terms (2 years), as well as a 24.9% reduction in the probability that both agencies impose the most severe penalty.

Among all the control variables, it is worth noting that the coefficient for "Firm Fine" in Table 2 as well as in subsequent tables, whenever statistically significant, is always negatively linked to government sanctions on fraudulent executives, suggesting a trade-off between individual penalties and firm fine. Intuitively, a fraudulent executive would prefer using firm resources to pay a fine rather than him paying the fine or risking more severe consequences. Since fining the firm harms the shareholders who have already been hurt by the executive's misconduct, our findings suggest that political contributions allow executives to shift the consequences of the fraud away from himself, even if that means shifting the consequences to the shareholders.

### 4.2. Instrumental Variable Analysis

Table 2 reveals that a larger amount of political contributions is significantly associated with more lenient penalties imposed upon fraudulent executives from government agencies. Nevertheless, as discussed in Subsection 2.4, the amount of political contributions and the decision to contribute are likely endogenous. Unobserved factors correlated with both the amount of political contributions and reduced government penalties may bias the results. To establish causality, we construct instruments for political contributions and undertake a two-stage least squares (2SLS) analysis.

Table 3 presents the regression estimates for our 2SLS analysis, in which the amount of political contributions is instrumented with variables involving politicians' offspring and previous contribution behaviors. Column 1 of Panel A reports the first stage regression estimates. The dependent variable is "Political Contributions". The key independent variables are the constructed instruments: "Daughters" and "Prior Contributions". Robust standard errors are clustered around the role of executive.

Consistent with the intuition for the instrument construction, column 1 of Panel A reveals that the coefficient estimate of "Daughters" is negative and significant at the 1% level. Conley and McCabe (2012) find that PACs respond to legislators' voting patterns by rewarding political candidates that vote in line with the positions of the PAC. Existing literature has established that being a conservative is partially explained by individual characteristics including income, age, gender, education, and race, and that individuals with conservative personal traits are more likely to identify with the Republican Party (e.g., Campbell et al. 1960 and Levitt 1996). Intuitively, local politicians with less liberal voting patterns are likely to attract more contributions from these executives and their firms. Also consistent with the literature that political contributions

tend to persist over time, the coefficient estimate of "Prior Contributions" is positively and highly significantly related to the current amount of political contributions.

Columns 2 through 4 report the second-stage regression estimates, with the executives' civil penalties as the dependent variable. The coefficient estimates of instrumented "Political Contributions" are negative for all measures of civil penalties, suggesting that an increase in the amount of political contributions leads to a decline in terms of monetary penalty as well a reduction in officer ban. The effect is also statistically significant except in column 2, when we do not scale monetary penalty by the compensation of the accused executive. This finding suggests that a larger amount of political contributions is beneficial for individual executives by reducing the severity of civil penalties.

The *F*-statistic of the first-stage in IV estimation is 23.25 for columns 2 and 4, and 10.98 for column 3, suggesting that the instruments in the first stage of the various regressions are highly correlated with the endogenous right-hand-side variable in the second stage, and that they provide relevant instruments for the amount of political contributions. In addition to the *F*-statistic for excluded instruments, we perform a series of tests to examine the validity of our IV analysis. The Anderson-Rubin Wald *F*-statistic is 42.41 for "Monetary Penalty/Compensation" and 5.41 for "Officer Ban", significant at the 1% and 10% levels, respectively, which shows that the instruments in the first-stage regression are strong. The Basmann test statistic is 0.03 for the test of "Monetary Penalty", 0.08 for "Monetary Penalty/Compensation", and 0.28 for "Officer Ban", none of which is statistically significant at the conventional level. This indicates that our instruments are not over-identified.

Panel B reports the 2SLS regression estimates for the criminal penalties and Panel C reports the IV regressions for severity measure, which incorporates both civil and criminal

penalties (i.e. “Prison & Ban”). Consistent with the results in Table 2, more political contributions lead to more lenient criminal penalties, and overall a reduction in the likelihood of receiving the most severe civil and criminal sanctions. The *F*-statistic for excluded instruments is 23.37 for Panels B and C, significant at the 1% level. The Anderson-Rubin Wald *F*-statistic is 9.97 for “Probation”, 80.94 for “Prison”, and 14.47 for “Prison & Ban”; all are statistically significant at the 1% level. The Basmann test statistic is 0.14 for the test of “Probation”, 0.11 for “Prison”, and 0.00 for “Prison & Ban”. None is significant at the conventional level confirming that our instrument is not over-identified.

### 4.3. Robustness

So far we provide evidence consistent with that political contributions limit the outcomes of government enforcements. To further identify the causal effect of political contributions on the severity of government sanctions, we explore alternative hypotheses that might otherwise explain the disparate penalties between fraudulent executives that make generous contributions and those that do not.

#### *4.3.1. Benefit Exceeds Harm to Shareholder*

It is possible that the magnitude of penalties may be driven by factors other than political contributions, or that the magnitude of penalties is a consequence of other effects caused by political contributions. For instance, existing literature has documented extensive evidence on how political connections affect firm value (e.g., Fisman 2001; Jayachandran 2006). Thus, the SEC and/or DOJ may impose a less severe sanction on an executive from a firm whose net benefit to shareholders is believed to be positive. Put differently, if an executive that has been accused of fraud has otherwise managed the firm well and has, on balance, increased shareholder wealth through his contribution to firm activities, the SEC/DOJ may take the net effect of his

work into consideration and propose a less severe penalty since shareholders are better off with the firm in place.

To take into account the potential net benefit to shareholders, we include in our baseline models a proxy for the benefit accrued to the shareholders by accused executives: the firm's return on equity (ROE), measured at the beginning of the fraudulent period. If political contributions do not directly affect the severity of government enforcement, but instead, simply proxy for the potential benefit to shareholders, we would expect that adding this control will cause our variable of interest to lose statistical significance.

Table 4 presents the results from the 2SLS estimations in which political contributions are instrumented by "Daughters" and "Prior Contributions". For brevity, only the second-stage results are tabulated. We find that ROE is not significantly related to the severity of penalties imposed upon accused executives. This suggests that when assessing penalties, the government does not consider the gains accrued to shareholders. Furthermore, controlling for the potential benefits that political contributions may generate, the instrumented political contributions continue to be significantly negatively related to the severity of penalty across nearly all specifications.

*4.3.2. Earned Leniency*

Another possibility is that if a firm (by extension of its top management) has put its best efforts forth to comply with SEC regulations, this compliance may earn that firm, as well as its employees, leniency for any wrongdoing. In fact, Files (2012) finds evidence of earned leniency in the form of reduced monetary penalties.

To take into account the potential leniency that the firm may have earned by being a "good corporate citizen", we re-estimate our baseline models by including a proxy for corporate governance that approximates managerial entrenchment—whether or not the firm has a classified

board.[15] Again, if political contributions simply proxy for earned leniency, we would expect that adding this control will cause our variable of interest to lose statistical significance.

The results are displayed in Table 5. While the presence of a classified board does positively affect one of the penalties assessed and the likelihood of receiving the harshest penalties from government agencies, the instrumented "Political Contributions" remains negatively and mostly significantly related to the magnitude of civil and criminal penalties after controlling for managerial entrenchment. This suggests that earned leniency does not fully explain the disparate penalties between contributing executives and non-contributing executives.

*4.3.3 Alternative Disciplining Mechanisms*

It is possible that the disparate penalties between fraudulent executives that make generous contributions and those that do not is not due to political contributions (or lack thereof), but rather a decision on the part of the agency to take into account other forms of discipline imposed on the executive and/or the firm. Along this line of reasoning, it would make sense for an agency to impose less severe penalties where the executive has already been penalized by the firm or market. For example, the SEC may find it unnecessary to impose an officer ban after the board of directors has terminated the executive for his role in the fraud.[16] Likewise, the agencies may be less inclined to impose a monetary penalty on the executive if the shareholders have already received restitution through class action litigation.

We augment our main analysis by including proxies for alternative discipline mechanisms that government agencies might potentially take into account when assessing penalties for the accused executives: termination by the board of directors, delisting by the

[15] A weak board is especially vulnerable in curbing executive greed, which exacerbates fraud incentives (Haynes, Campbell and Hitt 2017). In particular, a classified board hampers shareholders' ability to gain control of a board, and consequently, to affect their ability to dismiss ineffective CEOs (Fisman et al. 2014).

[16] Desai, Hogan and Wilkins (2006) and Karpoff, Lee and Martin (2008) find that executives are at a higher risk for termination following a restatement due to fraud.

primary exchanges (in many cases the delisted firm ceases to exist), and class action litigation. "Termination" is an indicator variable equal to one if the executive was involuntarily dismissed after revelation of the fraud but prior to the imposition of a penalty by the agency, and zero otherwise. "Delisted" is a binary variable equal to one if the firm was no longer publicly traded on a major exchange at the time the penalty was imposed, and zero otherwise. "Class Action" is equal to one is the executive was subject to a class action involving the same matter as the SEC charges, and zero otherwise.

Table 6 reports the second stage results from the IV regressions. There is limited evidence that when assessing various penalties, the government agencies take into account some of the three disciplining mechanisms, as the dummies for termination, delisting, and class action lawsuits are significantly related to certain types of penalties. More importantly, there remains a significantly negative relationship between political contributions and the penalty imposed by the SEC and DOJ across nearly all specifications, even controlling for market disciplinary mechanisms.

*4.3.4. Alternative Econometric Specifications*

In our main analysis, the independent variable of interest is the amount of political contributions. It is possible that it is the contribution decision, rather than the amount of contribution, that matters. As a robustness check, we re-estimate our baseline regressions replacing the amount of political contribution with an indicator variable equal to one if an individual executive or his/her firm contributes to political campaigns in the first year of the fraud and zero otherwise. As Table 7 Panel A indicates, we find similar results.

Throughout our main analyses, we control for various fixed effects to take into account observed and unobserved fraud-specific, industry-specific, firm-specific, and year-specific characteristics that can affect the severity of government penalty. To further address the concern

that unobserved factors correlated with both political contributions and the severity of penalty could bias the results, we apply an instrumental variable approach.

Alternatively, we estimate a two-step Heckman procedure taking into account the potential endogeneity in political contributions.[17] Following Cooper, Gulen and Ovtchinnikov (2010), we consider in the first step the decision to contribute and obtain the Inverse Mills Ratio (IMR). "Contributor" takes on a value of one if political contributions occur during the period of the fraud and zero otherwise. We control for firm-specific characteristics at the beginning of the fraud period (i.e., in the first year of the fraud) such as firm size, leverage, cash flows, market share, and market share squared, Herfindahl index, the number of business segments, the number of geographic segments, We also control for industry-specific characteristics that drive a firm's political contributions, such as a dummy variable indicating whether or not the firm's industry is regulated, the percentage of the industry that is unionized, and government purchases. In the second step, we control for self-selection in the decision to contribute by including the IMR, along with control variables on the type, length, and severity of the fraud, as well as other characteristics that may affect the severity of penalty.

Results are displayed in Table 7 Panel B. After controlling for the decision to make political contributions, contributing executives see significantly lower penalties than non-contributing executives across nearly all specifications.

As another robustness check (untabulated), we re-estimate our baseline tests using alternative ways to compute political contributions (contributions during the five years leading up to the first year of the fraud instead of during the fraud period, raw contribution dollars instead of log-transformed). We also consider additional controls for whether a decision had

[17] Our findings are also robust to using the Abadie and Imbens (2006) matching framework. The results are available upon request.

been made in an alternate case (i.e., criminal for civil and civil for criminal) and whether there is also individual contributions from a given executive. Our findings are invariant.

## 5. Mechanisms and Welfare

### 5.1 Potential Mechanisms

We now analyze how political contributions may channel personal benefits to fraudulent executives. Such an analysis is empirically challenging because, unlike publicly traded companies whose operating activities are readily observable, interactions between politicians and executives are nearly unobservable, and could take the form of phone calls, e-mails or even conversations at social/professional events. Indeed, finding a reliable, concrete link between political contributions and favors promised by members of Congress is a difficult, if not impossible, task. In support of this logic, an article in the Wall Street Journal notes that when executives and politicians don't want a record of communication, they often use the code "LDL", which stands for "let's discuss live". Nevertheless, in this subsection, we explore two potential mechanisms through which political contributions may allow fraudulent executives to receive more lenient sanctions.

*5.1.1. Agency's Discretion in the Outcome (Court Judgment vs. Plea / Settlement)*

When cases are brought to a federal court, the SEC can propose sanctions but the decision is ultimately left to the court (either the judge or a jury). Often these cases are settled prior to court judgment, in which case the agency has greater control over the penalty(ies). Likewise, cases prosecuted by the DOJ can result in either a court judgment, or can be settled by the agency through a plea bargain. Penalties determined by courts are usually significantly harsher. In our sample, for instance, fraudulent executives face $8.85 million more in monetary

penalty and 3.28 more years in prison if penalties are imposed by the court. *Ceteris paribus*, fraudulent executives would prefer the penalties be imposed by the government agencies rather than by the court.

To take into account this distinction, which may affect the severity of government penalty, we hand collect data on the resolution of the case to construct "Settlement/Plea Bargain", an indicator variable which takes on a value of one when the penalty results from a settlement with the SEC or a plea bargain with the DOJ, and zero when the penalty is imposed by the court (either the judge or a jury). In instances where we could not find information as to whether the outcome of the case took the form of a court judgment or a settlement/plea bargain, we assume that a settlement/plea bargain was used. This assumption is based on the fact that the majority of our sample (56% of civil cases and 82% of criminal cases) is resolved through a settlement or plea bargain. This assumption will obviously only bias against us finding the results in cases where a judgment was actually made.[18]

We start with a benchmark regression in column 1 of Table 8. The dependent variable is "Severity", a categorical variable equal to five if an accused executive receives the most severe civil and criminal penalties—officer ban and prison term, four if he receives prison term, three if there is an officer ban, two if there is probation, one if there is monetary penalty, and zero if no penalties are imposed. By construction, this variable captures the severity of the government enforcement. The key variable of interest is "Settlement/Plea Bargain". Column 1 confirms that when courts determine penalties, the penalties are significantly harsher, as the coefficient for the

[18] An example of this is Citigroup's proceedings. Citigroup and its executives were accused of deceiving investors by betting against more than $1 billion in mortgage backed securities sold to investors. The SEC offered to settle with Citigroup in exchange for a $285 million penalty, an amount Judge Radkoff referred to as mere "pocket change". ("Appeals court delays SEC Citigroup fraud case", December 27, 2011, Reuters, and "For S.E.C., court ruling on penalties ties a hand", November 30, 2011, The New York Times). Following Judge Radkoff, in a separate matter Judge Rudolph T. Randa requested the SEC explain how the agency's proposed settlement with Koss Corporation was "fair, adequate, and in the public's interest" ("An S.E.C. fraud settlement questioned, gets approved", February 2, 2012, The New York Times).

dummy variable "Settlement/Plea Bargain" is negative and is significant at the 1% level. This implies that all else equal, the accused executives would prefer the penalties set by the government agencies (SEC and/or DOJ) rather than by the court.

To explore whether avoiding court judgment is one of the underlying factors affecting the difference in severity of penalties between fraudulent executives that make generous contributions and those that do not, we proceed as follows. First, we regress "Settlement/Plea Bargain" on "Political Contributions" and calculate the predicted likelihood of achieving settlement with the SEC and/or plea bargain with the DOJ. "Predicted Settlement/Plea Bargain" thus captures the part of the propensity to settle with government agencies that is driven by political contributions from accused executives. In the second step, we regress "Severity" against this predicted likelihood of reaching settlement/plea bargain.

Column 2 of Table 8 reveals that the coefficient for "Predicted Settlement/Plea Bargain" is negative and is significant at the 1% level. This suggests that political contributions allow accused executive to receive less harsh, and certainly more desirable sanctions by settling with the government agencies instead of going to the court.

*5.1.2 Duration of Settlement*

Katz (2010) indicates that inside the SEC, enforcement actions that take longer to resolve are often closed with no resulting penalties, particularly when a new attorney is assigned the case or a new commissioner is appointed. This implies that if an executive can delay resolution of the case long enough, he could potentially also reduce the severity of the penalty imposed by the SEC. We examine this relationship in light of political contributions. Since we do not have any rationale for the DOJ that is similar to Katz's (2010) argument for the SEC, we focus on the civil penalties imposed by the SEC in this set of analysis. If political contributions from fraudulent

executives help delay enforcement outcomes by increasing time-to-resolution and the implications of Katz (2010) hold in our sample, the lengthening of case time-to-resolution may provide a mechanism through which political contributions affect the severity of penalties imposed by the SEC.

We compute "Time to Settle" as the number of years (or fraction thereof) it takes from initiation of the formal charges until resolution, whether it be settlement, plea, or court judgment. To explore whether the delay in time to settle with the SEC is the underlying factor affecting the difference in severity of civil penalties between fraudulent executives that make generous contributions and those that do not, we proceed similarly as in the tests for settlement with government agencies. First, we regress the time to settle with the SEC against the amount of political contributions and calculate the predicted time to settle. The predicted value thus captures the time to settle driven by the political contributions from accused executives. Since the time to settle is highly skewed, we also take the log transformation of the predicted value of time to settle with the SEC.

Next, we include the predicted time to settle with the SEC in the regression of the severity of civil penalty. The dependent variable, "Civil Severity", is set to two if a fraudulent executive receives the most harsh civil penalty—officer ban, one if there is monetary penalty, and zero if no civil penalties are involved. The higher the value of the variable, the more severe the civil penalty.

Table 9 reveals that the predicted time to settle is negatively and significantly related to the severity of civil penalty, and the relationship is significant at the 1% level. We interpret this as evidence consistent with the argument that lengthening the time to resolution due to the political contributions allows for less severe civil penalties.

### 5.2 The Effect of Political Contributions on Loss Accrued to Shareholders

So far, we have shown that political contributions impact negatively government penalties imposed upon fraudulent executives. In light of Correia (2014), who shows that political spending reduces the monetary penalties that a fraudulent firm received from the SEC, our findings suggest that the SEC capture through political connections is prevalent not only at firm level, but also occurs at individual level. More importantly, since the SEC may substitute a large penalty on the firm for a smaller penalty on the manager because it believes the firm-level penalties encourage optimal internal monitoring and enforcement, by distorting the enforcement process in ways that benefit managers, political contributions may allow executives to shift the consequences of the fraud away from themselves, even if that means shifting the consequences to the shareholders.

In this subsection, we examine whether the severity of penalty SEC imposes on firms varies with the government sanctions applied to individual executives, and to what extent political contributions affect this process. Column 1 of Table 10 reveals that "Severity" is negatively and significantly associated with "Firm Fine". As the severity of penalty of the fraudulent executive goes down, the amount of fine imposed on firm goes up, suggesting a shifting of responsibility. More importantly, the coefficient for the interaction term "Political Contributions" × "Severity" is negative and highly significant. The "transfer" of penalty between fraudulent managers and firms is more significant when political contributions are larger. Columns 2 and 3 provide evidence that the role of political contributions in affecting the severity of penalties applied to the firm and executives is significant both in civil penalty and criminal penalty. In columns 4 through 6, we show the robustness of the results by replacing the amount

of political contribution with an indicator variable for whether the executive and his firm have engaged in political spending. The findings are similar.

Overall, these tests indicate that while less severe penalties at executive level is associated with larger fines from SEC that cost shareholders, political contributions exacerbate such a relationship.

## 6. Conclusions

In this paper, we manually assemble a comprehensive set of data on individual penalties from government sanctions and examine the effect of political contributions on the severity of government enforcement imposed on fraudulent executives. We show that an increase in political contributions is associated with a significant reduction in monetary penalties, the number of years an executive is banned as an officer, sentenced to probation or prison, as well as a reduction in the probability that he will receive both an officer ban and prison time. These results are consistent with contributing executives facing less severe penalties from the SEC (in the case of civil penalties) or the DOJ (in the case of criminal penalties).

Further analyses suggest that the net benefit accrued to shareholders, earned leniency, as well as alternative disciplines (termination by the board, class action lawsuits and firm delisting) do not fully explain our findings. When exploring potential mechanisms, political contributions allow fraudulent executives to receive less harsh penalties by reducing the likelihood of having the court assessing the penalty. They also help lengthening the case time-to-settle with the SEC, resulting less severe civil penalty. Our findings provide the first evidence on how individual executives may use political connections for personal benefit. In particular, there is evidence that

political connections help facilitate the shift of fraud consequences from managers to shareholders.

These findings shed light on the factors determining the effectiveness of market-based disciplinary mechanisms. In particular, prior literature indicates that managers responsible for corporate financial fraud suffer negative career and monetary consequences. By documenting that larger political contributions lead to less severe sanctions, we highlight a mechanism that can undermine the disciplining effect for fraudulent managers and potentially exacerbate an executive's ex-ante incentive to commit fraud.

## Appendix: Variable Definitions

| Variable | Definition |
|---|---|
| # of Accused Executives | The number of accused executives at a given firm. Source: AAERs. |
| Civil Severity | A categorical variable equal to zero if the accused executive receives no civil penalties from the SEC, one if monetary penalty is imposed, and two if an officer ban is imposed. Source: Manual Collection. |
| Class Action | An indicator variable equal to one if a firm was subject to a shareholder class action litigation regarding the same matter as the SEC/DOJ investigation and zero otherwise. Source: Stanford Securities Class Action Clearinghouse. |
| Classified Board | An indicator variable equal to one if the firm has a classified board in the year penalties are imposed, and zero otherwise. Source: SEC EDGAR Proxy Statements. |
| Contributor | An indicator variable equal to one if the accused executive made political contributions during the fraudulent period, and zero otherwise. Source: Federal Election Commission. |
| Criminal Penalty | A categorical variable equal to zero if the accused executive receives no criminal penalty from the DOJ, one if probation is imposed, and two if a prison term is imposed. Source: Manual Collection. |
| Damages | The natural logarithm of the average size of the fraud (measured in dollars). Source: AAERs. |
| Daughters | The average annual number of Congressional members that have any daughters in the state where the firm whose executive is accused for fraud is headquartered scaled by the average number of Congressional seats, both of these averages calculated over the fraudulent period. Sources: Congressional Directories and Manual Collection. |
| Delisted | A binary variable equal to one if the firm is no longer publicly listed when penalties are imposed or went bankrupt prior to the time the penalty was imposed, and zero otherwise. Source: Lexis-Nexis. |
| Duration of Fraud | The number of years (or portion thereof) from the beginning of the fraud until the conclusion of the fraud. Source: AAERs. |
| Firm Fine | The natural logarithm of one plus the dollar amount of fine imposed on the firm by the SEC. Source: AAERs and Compustat. |
| Lobbying | An indicator variable equal to one if a firm has lobbying activities. Source: Center for Responsive Politics. |
| Monetary Penalty | The natural logarithm of one plus the dollar amount of monetary penalties (in millions of dollars) imposed on the executive by the SEC. Source: AAERs. |
| Monetary Penalty/ Compensation | The natural logarithm of one plus the amount of monetary penalty imposed on the accused executive by the SEC, scaled by the compensation of the accused executive. Source: AAERs, Execucomp and SEC EDGAR. |
| Officer Ban | The natural logarithm of one plus the number of years the accused executive is banned as an officer. Source: AAERs. |

| | |
|---|---|
| Political Contributions | The natural logarithm of one plus the average annual amount (in $10,000s) of political contributions that an accused executive made during the period of fraud. We include both contribution from the firm via PAC and contributions made directly by the accused executive. Sources: Federal Election Commission and Center for Responsive Politics. |
| Prior Contributions | An indicator equal to one if the firm has PAC contributions 15 years ago and zero otherwise. Source: Federal Election Commission. |
| Prison | The natural logarithm of one plus the number of years of prison that the accused executive received. Sources: AAERs, Corporate Counsel Fraud Database, Offices of the US Attorneys, and Lexis-Nexis. |
| Prison & Ban | An indicator variable equal to one if the accused executive receives both prison time and an officer ban, and zero otherwise. Sources: AAERs, Corporate Counsel Fraud Database, Offices of the US Attorneys, and Lexis-Nexis. |
| Probation | The natural logarithm of one plus the number of years of probation the accused executive received. Sources: AAERs, Corporate Counsel Fraud Database, Offices of the US Attorneys, and Lexis-Nexis. |
| Republican Appointed Chief | An indicator variable equal to one if the head of the respective agency (Commissioner for the SEC or Attorney General for the DOJ) was appointed by a republican president and zero if the head of the agency was appointed by a democratic president. Party affiliation is measured at the time penalties are imposed. Source: SEC and DOJ websites. |
| ROE | Return on equity defined as income before extraordinary items scaled by shareholder's equity. ROE is measured in the first year of the fraud. Source: CRSP and Compustat. |
| Settlement/Plea Bargain | An indicator variable equal to one if the case ended in a settlement (civil case) or plea bargain (criminal case), and equal to zero otherwise. Sources: AAERs, Corporate Counsel Fraud Database, Offices of the US Attorneys, and Lexis-Nexis. |
| Severity | A categorical variable equal to 5 if both prison and officer ban are imposed, 4 for prison term, 3 for an officer ban, 2 for probation, 1 if there is monetary penalty, and zero if no penalty is imposed. Source: Manual Collection. |
| Size | The natural logarithm of the firm's average market cap during the fraudulent period. Source: Compustat. |
| Small Firm | An indicator variable equal to one if the firm's total assets are less than $200 million. |
| SOX | An indicator variable that equals one if the resolution date occurs after the enactment of Sarbanes-Oxley (July 30, 2002) and zero otherwise. |
| Termination | An indicator variable equal to one if the executive was involuntarily dismissed after revelation of the fraud but prior to the imposition of a penalty by the agency and zero otherwise. Termination is calculated using the methodology of Parrino (1997). Sources: Execucomp, SEC EDGAR, and Lexis-Nexis. |
| Time to Settle | The natural logarithm of the number of years (or fraction thereof) from |

| | |
|---|---|
| | the formal charges by the SEC until the resolution (settlement or court judgment). Source: AAERs. |

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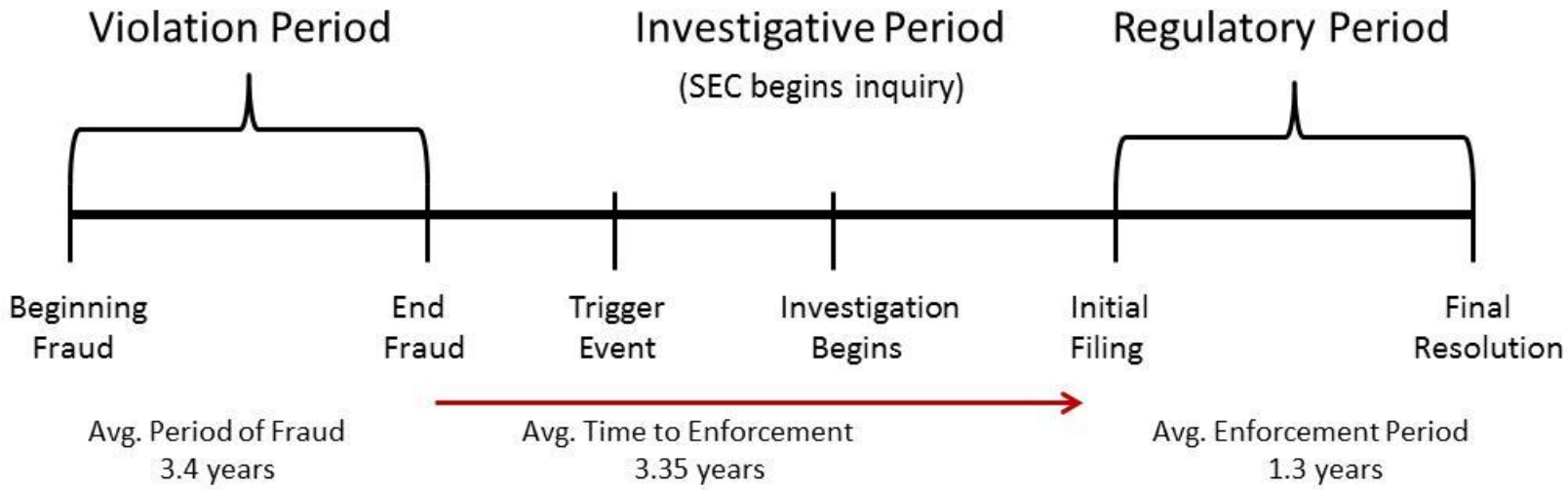
**Figure 1. Timeline of SEC Enforcement Action**

The figure illustrates the timeline of the SEC enforcement actions for our sample. "Beginning Fraud" is the fiscal year in which the executive first became engaged in the fraudulent behavior. "End Fraud" is the last fiscal year of the alleged fraud. "Time to Enforcement" is the difference between the last fiscal year of the fraud and the formal filing of the SEC complaint (for civil actions). "Regulatory Period" represents the time from the formal filing of the action by the SEC until the final resolution by the SEC. The resolution date typically refers to the resolution of the civil action; criminal actions may not be resolved until a later point in time.



## Table 1: Descriptive Statistics

The sample period is 1999-2010. In Panel A, "Contributor" is a dummy variable equal to one if an accused executive and his firm made political contributions during the sample period and zero otherwise. Panel B reports the distribution of the roles of the accused executives and the types of fraud they are accused of. CEO is the Chief Executive Officer. CFO is the Chief Financial Officer. COO is the Chief Operating Officer. CIO is the Chief Information Officer. CAO is the Chief Accounting Officer. Panel C reports the descriptive statistics of enforcement types. The last column reports the Wilcoxon rank-sum test statistics comparing the contributing and the non-contributing subsamples. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

### Panel A: Political Contributions and Fraud Characteristics

| | # of obs. | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|---|
| Contributor | 452 | 0.22 | 0.41 | 0 | 1 |
| Political Contribution ($10,000) | 452 | 1.54 | 4.52 | 0 | 33.24 |
| Total Assets ($ millions) | 452 | 9,273.97 | 40,301.21 | 2.50 | 492,982 |
| Firm Fine ($ millions) | 452 | 40.55 | 245.47 | 0.00 | 2,250 |
| Damages ($ millions) | 452 | 498.81 | 1,536.21 | 0.09 | 11,000 |
| # of Accused Executives | 452 | 3.68 | 2.15 | 1 | 9 |
| Duration of Fraud (years) | 452 | 3.30 | 2.29 | 1 | 16 |

### Panel B: Executives and Fraud Type

| | # of obs. | Earnings Fraud | Securities Fraud | Options Backdating | Bribery | Insider Trading | Embezzlement |
|---|---|---|---|---|---|---|---|
| CAO | 18 | 17 | 5 | 2 | 0 | 1 | 0 |
| CEO | 79 | 71 | 17 | 11 | 0 | 6 | 0 |
| CFO | 144 | 132 | 23 | 14 | 0 | 10 | 2 |
| Chairman | 5 | 4 | 0 | 1 | 0 | 0 | 0 |
| CIO | 1 | 1 | 0 | 0 | 0 | 0 | 0 |
| Controller | 67 | 63 | 8 | 4 | 0 | 3 | 1 |
| COO | 15 | 15 | 1 | 1 | 0 | 2 | 0 |
| Director | 13 | 9 | 3 | 2 | 1 | 0 | 0 |
| General Counsel | 10 | 10 | 1 | 3 | 0 | 0 | 1 |
| President | 13 | 12 | 1 | 0 | 1 | 0 | 0 |
| Treasurer | 2 | 2 | 1 | 0 | 0 | 0 | 0 |
| Vice President | 85 | 75 | 14 | 5 | 1 | 4 | 0 |
| Total | 452 | 411 | 74 | 43 | 3 | 26 | 4 |

**Table 1 continued.**

**Panel C: Enforcement Outcome and Political Contributions**

| Penalties | | # of obs. | Mean | Std. Dev. | 25th | Median | 75th | Z-statistics |
|---|---|---|---|---|---|---|---|---|
| | All Executives | 452 | 6.04 | 2.24 | 0.03 | 0.10 | 0.48 | |
| Monetary Penalty ($ millions) | Contributors | 99 | 9.75 | 5.38 | 0.05 | 0.15 | 0.83 | -3.11*** |
| | Non-contributors | 353 | 5.00 | 2.44 | 0.03 | 0.09 | 0.41 | |
| | All Executives | 192 | 2.94 | 1.10 | 0.05 | 0.18 | 0.76 | |
| Monetary Penalty/Compensation | Contributors | 29 | 2.77 | 1.99 | 0.14 | 0.32 | 0.53 | -1.66* |
| | Non-contributors | 163 | 2.97 | 1.25 | 0.04 | 0.15 | 0.77 | |
| | All Executives | 452 | 7.99 | 0.53 | 0.00 | 4.50 | 10.00 | |
| Officer Ban (years) | Contributors | 99 | 5.82 | 0.97 | 0.00 | 3.00 | 5.00 | -2.19** |
| | Non-contributors | 353 | 8.59 | 0.62 | 0.00 | 5.00 | 10.00 | |
| | All Executives | 138 | 1.25 | 0.14 | 0.00 | 0.00 | 3.00 | |
| Probation (years) | Contributors | 38 | 0.21 | 0.10 | 0.00 | 0.00 | 0.00 | -4.79*** |
| | Non-contributors | 100 | 1.65 | 0.18 | 0.00 | 1.50 | 3.00 | |
| | All Executives | 138 | 2.02 | 0.29 | 0.00 | 0.25 | 2.50 | |
| Prison (years) | Contributors | 38 | 1.27 | 0.42 | 0.00 | 0.00 | 1.50 | -3.06*** |
| | Non-contributors | 100 | 2.30 | 0.37 | 0.00 | 1.00 | 3.00 | |
| | All Executives | 138 | 0.43 | 0.04 | | | | |
| Prison & Ban | Contributors | 38 | 0.26 | 0.07 | | | | -2.40** |
| | Non-contributors | 100 | 0.49 | 0.05 | | | | |

## Table 2: Political Contributions and Government Penalties

This table reports the regression analyses examining the effect of political contributions on the severity of government penalties. The dependent variables in columns 1-6 are, respectively, "Monetary Penalty", "Monetary Penalty/Compensation", "Officer Ban", "Probation", "Prison", and "Prison & Ban". Column 6 reports the marginal effects from the Probit analysis. All models include dummies for fraud type, executive role, industry, settlement year, as well as a constant (except for column 6), but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered at the role of the accused executive are in brackets. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | OLS | OLS | Tobit | Tobit | Tobit | Probit |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Political Contributions | -0.11** | -0.22*** | -0.49*** | -1.17*** | -1.06*** | -0.75*** |
| | [0.041] | [0.058] | [0.020] | [0.015] | [0.021] | [0.222] |
| Lobbying | -0.05 | -0.69** | 0.68*** | 3.01*** | 2.51*** | 0.79*** |
| | [0.147] | [0.246] | [0.041] | [0.030] | [0.068] | [0.042] |
| Size | 0.12*** | 0.07* | -0.06*** | -0.07*** | -0.17*** | -0.07 |
| | [0.031] | [0.033] | [0.001] | [0.000] | [0.001] | [0.046] |
| Small Firm | 0.15* | 0.53** | 0.00 | 0.80*** | 0.08*** | 0.08 |
| | [0.070] | [0.169] | [0.021] | [0.018] | [0.023] | [0.087] |
| Firm Fine | -0.01** | 0.00 | -0.01*** | -0.08*** | -0.05*** | -0.01 |
| | [0.006] | [0.012] | [0.001] | [0.001] | [0.002] | [0.013] |
| Damages | 0.11* | 0.10* | 0.05*** | 0.06*** | -0.03*** | -0.05** |
| | [0.052] | [0.052] | [0.000] | [0.000] | [0.001] | [0.023] |
| # of Accused Executives | -0.09 | -0.11** | 0.33*** | 0.88*** | 0.82*** | 0.51 |
| | [0.109] | [0.035] | [0.006] | [0.014] | [0.013] | [0.317] |
| Duration of Fraud | 0.17* | 0.31** | 0.36*** | 0.34*** | -0.51*** | -0.35*** |
| | [0.094] | [0.112] | [0.012] | [0.011] | [0.007] | [0.122] |
| Republican Appointed Chief | -0.89*** | -0.54** | 0.05*** | 5.75*** | -0.27*** | -0.30* |
| | [0.094] | [0.226] | [0.019] | [0.022] | [0.020] | [0.182] |
| SOX | 0.43 | -0.36 | -10.45*** | 1.90*** | -4.41*** | -0.92*** |
| | [0.288] | [0.231] | [0.021] | [0.021] | [0.010] | [0.034] |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 452 | 192 | 452 | 138 | 138 | 132 |
| R-squared | 0.39 | 0.48 | 0.08 | 0.38 | 0.28 | 0.49 |

## Table 3: Instrumental Variable Analysis

This table reports the 2SLS regression analyses examining the effect of political contributions on the severity of government penalties. We instrument "Political Contributions" with "Daughters" and "Prior Contributions". In all panels, column 1 reports the first-stage results, which generate the fitted (instrumented) value of "Political Contributions" for use in the second-stage regressions. The rest of the columns report the results from the second-stage regressions. In Panel A, the dependent variables for columns 2-4 are civil penalty proxies: "Monetary Penalty", "Monetary Penalty/Total Compensation", and "Officer Ban". In Panel B, the dependent variables for columns 2-3 are criminal penalty proxies: "Probation" and "Prison". In Panel C, the dependent variable in the second stage is "Prison & Ban". All models include dummies for fraud type, executive role, industry, settlement year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered at the role of the accused executive are in brackets. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

### Panel A: Civil Penalties

| | First Stage | Second Stage | | |
|---|---|---|---|---|
| Dependent Variable | Political Contributions | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban |
| | (1) | (2) | (3) | (4) |
| Daughters | -1.13*** | | | |
| | [0.277] | | | |
| Prior Contributions | 0.74*** | | | |
| | [0.109] | | | |
| Political Contributions | | -0.10 | -0.39*** | -0.69** |
| | | [0.074] | [0.119] | [0.330] |
| Lobbying | 0.37 | -0.06 | -0.67*** | 0.68*** |
| | [0.212] | [0.142] | [0.239] | [0.243] |
| Size | 0.18*** | 0.11*** | 0.11*** | 0.02 |
| | [0.030] | [0.031] | [0.016] | [0.085] |
| Small Firm | 0.21** | 0.15** | 0.57*** | 0.04 |
| | [0.075] | [0.065] | [0.164] | [0.169] |
| Firm Fine | 0.01 | -0.01*** | 0.00 | 0.00 |
| | [0.007] | [0.005] | [0.010] | [0.008] |
| Damages | -0.02 | 0.11** | 0.11** | 0.02 |
| | [0.014] | [0.047] | [0.046] | [0.044] |
| # of Accused Executives | -0.06 | -0.09 | -0.11*** | 0.23** |
| | [0.061] | [0.099] | [0.031] | [0.094] |
| Duration of Fraud | 0.09* | 0.17** | 0.31*** | 0.29*** |
| | [0.046] | [0.087] | [0.093] | [0.112] |

| | | | | |
|---|---|---|---|---|
| Republican Appointed Chief | 0.19* | -0.23 | -0.48*** | 0.17 |
| | [0.106] | [0.172] | [0.169] | [0.177] |
| SOX | 0.01 | 0.43 | -0.37* | -1.46*** |
| | [0.107] | [0.262] | [0.204] | [0.241] |
| Fraud Type FE | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes |
| Observations | 452 | 452 | 192 | 452 |
| R-squared | 0.60 | 0.39 | 0.47 | 0.20 |

## Table 3 continued

## Panel B: Criminal Penalties

| Dependent Variable | First Stage | Second Stage | |
|---|---|---|---|
| | Political Contributions | Probation | Prison |
| | (1) | (2) | (3) |
| Daughters | -1.57*** | | |
| | [0.486] | | |
| Prior Contributions | 1.36*** | | |
| | [0.201] | | |
| Political Contributions | | -0.54*** | -0.97*** |
| | | [0.195] | [0.133] |
| Lobbying | -0.95** | 1.08*** | 1.14*** |
| | [0.306] | [0.144] | [0.414] |
| Size | 0.14*** | 0.00 | 0.01 |
| | [0.034] | [0.044] | [0.059] |
| Small Firm | 0.24 | 0.36** | 0.20 |
| | [0.202] | [0.150] | [0.182] |
| Firm Fine | -0.02* | -0.03** | -0.03** |
| | [0.008] | [0.012] | [0.010] |
| Damages | 0.01 | 0.03 | 0.03 |
| | [0.015] | [0.034] | [0.030] |
| # of Accused Executives | 0.37*** | 0.43* | 0.60*** |
| | [0.104] | [0.236] | [0.099] |
| Duration of Fraud | -0.05 | 0.02 | -0.41*** |
| | [0.101] | [0.076] | [0.087] |
| Republican Appointed Chief | -0.41 | 0.72*** | -0.24 |
| | [0.352] | [0.164] | [0.182] |
| SOX | -0.42* | 1.23*** | 0.02 |
| | [0.219] | [0.407] | [0.144] |
| Fraud Type FE | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes |
| Observations | 138 | 138 | 138 |
| R-squared | 0.73 | 0.52 | 0.38 |

**Table 3 continued.**

**Panel C: Both Civil and Criminal Penalties**

| Dependent Variable | First Stage | Second Stage |
|---|---|---|
| | Political Contributions | Prison & Ban |
| | (1) | (2) |
| Daughters | -1.57*** | |
| | [0.486] | |
| Prior Contributions | 1.36*** | |
| | [0.201] | |
| Political Contributions | | -0.34*** |
| | | [0.106] |
| Lobbying | -0.95** | 0.61*** |
| | [0.306] | [0.155] |
| Size | 0.14*** | -0.03 |
| | [0.034] | [0.030] |
| Small Firm | 0.24 | 0.00 |
| | [0.202] | [0.093] |
| Firm Fine | -0.02* | 0.00 |
| | [0.008] | [0.003] |
| Damages | 0.01 | -0.03*** |
| | [0.015] | [0.005] |
| # of Accused Executives | 0.37*** | 0.20** |
| | [0.104] | [0.090] |
| Duration of Fraud | -0.05 | -0.19*** |
| | [0.101] | [0.061] |
| Republican Appointed Chief | -0.41 | 0.00 |
| | [0.352] | [0.030] |
| SOX | -0.42* | -0.31*** |
| | [0.219] | [0.096] |
| Fraud Type FE | Yes | Yes |
| Executive Role FE | Yes | Yes |
| Industry FE | Yes | Yes |
| Settlement Year FE | Yes | Yes |
| Observations | 138 | 138 |
| R-squared | 0.73 | 0.49 |

**Table 4: Benefit to Shareholders Exceeds Harm**

This table presents the results from the 2SLS regressions examining the benefit to the firm's shareholders in comparison to the damage caused by the fraud. We instrument "Political Contributions" with "Daughters" and "Prior Contributions". The dependent variables for columns 1-6 are "Monetary Penalty", "Monetary Penalty/Total Compensation", "Officer Ban", "Probation", "Prison", and "Prison & Ban", respectively. For brevity, the first-stage regression in which the fitted (instrumented) value of "Political Contributions" is generated for use in the second-stage regressions is not tabulated. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered at the role of the accused executive are in brackets. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Political Contributions | -0.11 | -0.40*** | -0.65** | -0.59*** | -0.93*** | -0.33*** |
| | [0.074] | [0.108] | [0.325] | [0.192] | [0.119] | [0.108] |
| ROE | -0.01 | -0.01 | -0.01 | 0.00 | 0.01 | -0.01 |
| | [0.009] | [0.008] | [0.009] | [0.013] | [0.011] | [0.004] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 445 | 191 | 445 | 135 | 135 | 135 |
| R-squared | 0.39 | 0.47 | 0.22 | 0.51 | 0.38 | 0.50 |

## Table 5: Earned Leniency

This table presents the results from the 2SLS regressions examining the management entrenchment in comparison to the damage caused by the fraud. We instrument "Political Contributions" with "Daughters" and "Prior Contributions". The dependent variables for columns 1-6 are "Monetary Penalty", "Monetary Penalty/Total Compensation", "Officer Ban", "Probation", "Prison", and "Prison & Ban", respectively. For brevity, the first-stage regression in which the fitted (instrumented) value of "Political Contributions" is generated for use in the second-stage regressions is not tabulated. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered around the role of the accused executive are in brackets. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Political Contributions | -0.19 | -0.44** | -0.86** | -0.49** | -0.97*** | -0.33*** |
| | [0.145] | [0.222] | [0.388] | [0.199] | [0.177] | [0.111] |
| Classified Board | -0.05 | -0.18 | 0.03 | 0.09 | 0.59*** | 0.21** |
| | [0.096] | [0.126] | [0.201] | [0.177] | [0.089] | [0.098] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 364 | 168 | 364 | 114 | 114 | 114 |
| R-squared | 0.4 | 0.46 | 0.24 | 0.63 | 0.59 | 0.55 |

## Table 6: Alternative Disciplining Mechanisms

This table reports the 2SLS regression analyses examining how the effect of political contributions on civil and criminal penalty imposed upon fraudulent executives varies with a government agency's discretion. We instrument "Political Contributions" with "Daughters" and "Prior Contributions". The dependent variable in columns 1-6 is "Monetary Penalty", "Monetary Penalty/Compensation", "Officer Ban", "Probation", "Prison", and "Prison & Ban", respectively. For brevity, the first-stage regression in which the fitted (instrumented) value of "Political Contributions" is generated for use in the second-stage regressions is not tabulated. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Definitions of variables are in the Appendix. Robust standard errors clustered around the role of the accused executive are reported in brackets. *, **, and *** indicate significance levels of 10%, 5%, and 1% respectively.

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Political Contributions | -0.04 | -0.42*** | -0.66** | -0.60*** | -0.94*** | -0.32** |
| | [0.094] | [0.116] | [0.320] | [0.222] | [0.157] | [0.129] |
| Class Action | 0.00 | -0.01*** | 0.01** | 0.00 | 0.01 | 0.00 |
| | [0.005] | [0.002] | [0.004] | [0.011] | [0.011] | [0.004] |
| Termination | 0.32*** | 0.23*** | 0.40*** | -0.17 | 0.12 | 0.13 |
| | [0.064] | [0.073] | [0.043] | [0.124] | [0.232] | [0.105] |
| Delisted | 0.00 | 0.20*** | 0.16 | -0.14 | 0.05 | -0.06 |
| | [0.106] | [0.027] | [0.116] | [0.160] | [0.200] | [0.057] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 420 | 183 | 420 | 135 | 135 | 135 |
| R-squared | 0.41 | 0.51 | 0.24 | 0.52 | 0.39 | 0.50 |

## Table 7: Alternative Econometric Specifications

Panel A reports the 2SLS regression analyses examining how the decision to contribute affects the civil and criminal penalty(ies) imposed upon accused executives. We instrument the dummy variable "Contributor" with "Daughters" and "Prior Contributions". Panel B reports the results from the 2nd stage of the Heckman procedure to control for self-selection bias in the decision to contribute. For both panels, the dependent variable in columns 1 through 6 is "Monetary Penalty", "Monetary Penalty/Compensation", "Officer Ban", "Probation", "Prison", and "Prison & Ban", respectively. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered around the role of the accused executive are reported in brackets. *, **, and *** indicate significance levels of 10%, 5%, and 1% respectively.

**Panel A: Decision to Contribute**

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Contributor | -0.18 | -0.61*** | -1.02** | -0.63*** | -1.40*** | -0.45* |
| | [0.123] | [0.165] | [0.475] | [0.246] | [0.223] | [0.254] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 452 | 192 | 452 | 138 | 138 | 138 |
| R-squared | 0.39 | 0.46 | 0.18 | 0.55 | 0.44 | 0.47 |

**Panel B: Heckman Procedure**

| Dependent Variable | Monetary Penalty | Monetary Penalty/ Compensation | Officer Ban | Probation | Prison | Prison & Ban |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Political Contributions | -0.08* | -0.23*** | -0.38*** | -1.45*** | -0.92*** | -0.85*** |
| | [0.043] | [0.059] | [0.025] | [0.007] | [0.041] | [0.287] |
| Inverse Mills Ratio | -0.05 | -0.09** | 0.08*** | -0.44*** | -0.09*** | -0.04 |
| | [0.073] | [0.030] | [0.008] | [0.011] | [0.014] | [0.319] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Observations | 418 | 179 | 418 | 126 | 126 | 114 |
| R-squared | 0.38 | 0.47 | 0.09 | 0.42 | 0.27 | 0.48 |

**Table 8: Mechanisms — Agency Discretion in the Outcome**

This table reports the OLS regression results examining how the effect of political contributions on the severity of government enforcement varies with a government agency's discretion. The dependent variable is "Severity", a variable equal to 5 if both prison and officer ban are imposed, 4 for prison term, 3 for an officer ban, 2 for probation, 1 if there is monetary penalty, and zero if no penalty is imposed. In column 1, "Settlement/Plea Bargain" is a dummy variable equal to one if the penalty results from a settlement with the SEC and/or plea bargain with the DOJ, and zero if the penalty is imposed by the court (either the judge or a jury). In column 2, "Predicted Settlement/Plea Bargain" is the predicted value from regressing "Settlement/Plea Bargain" on "Political Contributions", multiplied by 100. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Definitions of variables are in the Appendix. Robust standard errors clustered around the role of the accused executive are reported in brackets. ***, **, and * indicate significance at the 1%, 5%, and 10% level, respectively.

| Dependent Variable | Severity | |
|---|---|---|
| | (1) | (2) |
| Settlement/Plea Bargain | -2.11*** | |
| | [0.134] | |
| Predicted Settlement/Plea Bargain | | -0.92*** |
| | | [0.212] |
| Control Variable | Yes | Yes |
| Fraud Type FE | Yes | Yes |
| Executive Role FE | Yes | Yes |
| Industry FE | Yes | Yes |
| Settlement Year FE | Yes | Yes |
| Observations | 452 | 452 |
| R-squared | 0.24 | 0.19 |

## Table 9: Mechanisms — Time to Settle with the SEC

This table reports the OLS regression results examining how political contributions affect civil penalty imposed upon fraudulent executives via increasing time-to-resolution with the SEC. The dependent variable is "Civil Severity", equal to two for officer ban, one for monetary penalty, and zero for no civil penalty. The key independent variable is predicted value of "Time to Settle", the duration it takes for the case to reach a resolution with the government agency. The predicted time to settle is generated from regressing "Political Contributions" on "Time to Settle". All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered around the role of the accused executive are reported in brackets. *, **, and *** indicate significance levels of 10%, 5%, and 1% respectively.

| Dependent Variable | Civil Severity | |
|---|---|---|
| | (1) | (2) |
| Predicted Time to Settle | -0.62*** | |
| | [0.143] | |
| Log (Predicted Time to Settle) | | -1.86*** |
| | | [0.429] |
| Control Variable | Yes | Yes |
| Fraud Type FE | Yes | Yes |
| Executive Role FE | Yes | Yes |
| Industry FE | Yes | Yes |
| Settlement Year FE | Yes | Yes |
| Observations | 452 | 452 |
| R-squared | 0.19 | 0.19 |

## Table 10: Political Contributions and Penalty Shift to Shareholders

This table relates the severity of personal penalty to the loss accrued to shareholders. The dependent variable is "Firm Fine". "Severity" is a categorical variable equal to 5 if a fraudulent executive receives both prison and officer ban, 4 for prison term, 3 for an officer ban, 2 for probation, 1 if there is monetary penalty, and zero if no penalty is imposed. "Civil Severity" is categorical variable equal to zero if the accused executive receives no civil penalties from the SEC, one if monetary penalty is imposed, and two if an officer ban is imposed. "Criminal Severity" is a categorical variable equal to zero if the accused executive receives no criminal penalty from the DOJ, one if probation is imposed, and two if a prison term is imposed. All models include control variables, dummies for fraud type, executive role, industry, resolution year, as well as a constant, but the coefficients are not tabulated. Fraud type is one of the following: earnings fraud, securities fraud, options backdating, insider trading, embezzlement, bribery, or earnings restatement. Executive roles are one of the twelve roles identified in Table 1, Panel B. Industry classifications are based on 1-digit SIC code. Variable definitions and constructions are in the Appendix. Robust standard errors clustered around the role of the accused executive are reported in brackets. *, **, and *** indicate significance levels of 10%, 5%, and 1% respectively.

| Dependent Variable | Firm Fine | | | | | |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| Severity | -1.11*** | | | -0.95*** | | |
| | [0.025] | | | [0.035] | | |
| Political Contributions × Severity | -0.71*** | | | | | |
| | [0.108] | | | | | |
| Civil Severity | | -1.10*** | | | -0.40*** | |
| | | [0.028] | | | [0.029] | |
| Political Contributions × Civil Severity | | -1.07*** | | | | |
| | | [0.172] | | | | |
| Criminal Severity | | | -1.09*** | | | -0.58*** |
| | | | [0.046] | | | [0.051] |
| Political Contributions × Criminal Severity | | | -0.14 | | | |
| | | | [0.143] | | | |
| Contributor × Severity | | | | -0.91*** | | |
| | | | | [0.060] | | |
| Contributor × Civil Severity | | | | | -2.38*** | |
| | | | | | [0.112] | |
| Contributor × Criminal Severity | | | | | | -0.84*** |
| | | | | | | [0.117] |
| Political Contributions | -2.85*** | -2.35*** | -3.66*** | | | |
| | [0.272] | [0.280] | [0.249] | | | |
| Contributor | | | | -4.01*** | -3.08*** | -3.58*** |
| | | | | [0.185] | [0.199] | [0.184] |
| Control Variables | Yes | Yes | Yes | Yes | Yes | Yes |
| Fraud Type FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Executive Role FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Industry FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Filing Year FE | Yes | Yes | Yes | Yes | Yes | Yes |
| Settlement Year FE | Yes | Yes | Yes | Yes | Yes | Yes |

| | | | | | | |
|---|---|---|---|---|---|---|
| Observations | 452 | 452 | 452 | 452 | 452 | 452 |
| Pseudo R-squared | 0.269 | 0.266 | 0.265 | 0.269 | 0.267 | 0.266 |