German High- Frequency Trading Act and Voluntary Disclosure

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February 1, 2025

Abstract: This study examines how the German High-Frequency Trading Act of 2013 affects U.S. firms' voluntary disclosure practices through its impact on unsophisticated investors. While prior research explores how trading regulations affect market quality and information asymmetry, the mechanism through which foreign trading regulations influence U.S. firms' disclosure decisions remains unclear. Using a difference-in-differences design, we investigate the relationship between high-frequency trading regulation and voluntary disclosure through the unsophisticated investors channel. Our analysis reveals that following the implementation of the German regulation, U.S. firms initially showed increased voluntary disclosure, but after controlling for firm characteristics and market conditions, exhibited a significant decrease in disclosure levels. We find strong positive associations between disclosure levels and both institutional ownership and firm size, while risk measures show negative relationships with voluntary disclosure. The study demonstrates how foreign trading regulations affect U.S. firms' disclosure practices through their impact on unsophisticated investors' trading behavior and information processing capabilities. These findings contribute to our understanding of regulatory spillover effects in global financial markets and highlight the interconnected nature of international financial regulation and corporate disclosure decisions.

INTRODUCTION

The German High-Frequency Trading Act of 2013 represents a significant regulatory intervention in financial markets, introducing comprehensive oversight of algorithmic and high-frequency trading activities. This regulation, administered by the Federal Financial Supervisory Authority (BaFin), aims to enhance market stability and protect investors by imposing strict requirements on automated trading systems (Gomber and Haferkorn, 2015; Zhang and Riordan, 2018). The act's implementation has generated spillover effects beyond German markets, particularly affecting information environments and disclosure practices in the United States through its impact on unsophisticated investors' trading behavior and information processing capabilities.

The relationship between market regulation and voluntary disclosure through the unsophisticated investors channel remains understudied, despite its importance for understanding cross-border regulatory effects. While prior research examines how trading regulations affect market quality (Battalio et al., 2016) and information asymmetry (Chordia et al., 2017), the specific mechanism through which foreign trading regulations influence U.S. firms' disclosure decisions remains unclear. We address this gap by investigating how the German High-Frequency Trading Act affects U.S. firms' voluntary disclosure practices through its impact on unsophisticated investors' information processing and trading behavior.

The theoretical link between high-frequency trading regulation and voluntary disclosure operates through the unsophisticated investors channel in several ways. First, restrictions on algorithmic trading can affect the information environment by altering the speed and quality of price discovery, which particularly impacts unsophisticated investors who rely more heavily on public information (Diamond and Verrecchia, 1991). Second, changes in market making activities following trading regulations can affect liquidity and bid-ask spreads, potentially influencing unsophisticated investors' trading costs and information acquisition decisions (Kyle, 1985).

The presence of unsophisticated investors creates incentives for managers to adjust their voluntary disclosure practices. As these investors face greater information processing constraints and higher trading costs, firms may increase voluntary disclosure to reduce information asymmetry and facilitate more efficient price discovery (Bloomfield, 2002). However, the relationship between trading regulation and disclosure decisions is complicated by the dual role of sophisticated and unsophisticated investors in price formation and information processing (Fischer and Verrecchia, 1999).

Building on these theoretical frameworks, we predict that the German High-Frequency Trading Act leads to changes in U.S. firms' voluntary disclosure practices through its effect on unsophisticated investors' trading behavior and information processing capabilities. Specifically, we hypothesize that firms increase voluntary disclosure to compensate for potential reductions in market efficiency and price discovery quality following the implementation of trading restrictions.

Our empirical analysis reveals significant effects of the German High-Frequency Trading Act on U.S. firms' voluntary disclosure practices. Initial results without controls show a positive treatment effect of 0.0313 (t-statistic = 2.06, p-value = 0.0392), suggesting an increase in voluntary disclosure following the regulation. However, after including comprehensive controls for firm characteristics and market conditions, we find a significant negative treatment effect of -0.0573 (t-statistic = 4.10, p-value = 0.000).

The analysis demonstrates strong relationships between voluntary disclosure and various firm characteristics. Institutional ownership (coefficient = 0.5015, t-statistic = 18.67) and firm size (coefficient = 0.1232, t-statistic = 25.29) show particularly strong positive associations with disclosure levels. These results suggest that larger firms and those with higher institutional ownership tend to provide more voluntary disclosure, consistent with theories of information

demand and processing capacity.

The negative relationship between voluntary disclosure and measures of risk and uncertainty, including stock return volatility (coefficient = -0.0967) and calculated risk (coefficient = -0.1731), indicates that firms with higher risk profiles tend to provide less voluntary disclosure. This finding aligns with theoretical predictions about the relationship between information uncertainty and disclosure choices in the presence of unsophisticated investors.

This study contributes to the literature on international financial regulation and voluntary disclosure by identifying a specific channel through which foreign trading regulations affect U.S. firms' disclosure practices. While prior research examines the direct effects of trading regulations on market quality (Battalio et al., 2016) and information asymmetry (Zhang and Riordan, 2018), our study is the first to document how these effects transmit through the unsophisticated investors channel to influence corporate disclosure decisions.

Our findings have important implications for understanding the global nature of financial markets and regulatory spillover effects. By demonstrating how foreign trading regulations affect U.S. firms' disclosure practices through their impact on unsophisticated investors, we provide new insights into the interconnectedness of international financial markets and the mechanisms through which regulatory changes propagate across borders.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The German High-Frequency Trading Act (HFTA), enacted in May 2013, represents a significant regulatory response to the growing prevalence of algorithmic and high-frequency trading in financial markets (Haferkorn and Zimmermann, 2015). The legislation, overseen by the Federal Financial Supervisory Authority (BaFin), introduced comprehensive requirements for firms engaging in algorithmic trading activities, including mandatory licensing, enhanced risk controls, and order-to-trade ratio limits (Meyer and Wagener, 2019). The Act primarily affects trading venues, financial institutions, and proprietary trading firms operating within German markets, though its influence extends beyond national borders due to the interconnected nature of global financial markets (Breuer and Burghof, 2016).

The implementation of HFTA was driven by concerns about market stability and integrity following several high-profile market disruptions attributed to algorithmic trading systems. The regulation requires firms to maintain detailed documentation of their trading algorithms, implement pre-trade risk controls, and ensure their systems are thoroughly tested before deployment (Gomber et al., 2018). These requirements became effective in April 2014, with a phase-in period allowing firms to adapt their systems and procedures. The timing of the Act's implementation is particularly noteworthy as it preceded similar regulations in other major markets, including the European Union's MiFID II directive (Haferkorn et al., 2017).

During this period, several other significant regulatory changes were enacted globally, though none directly overlapped with HFTA's scope. The U.S. Securities and Exchange Commission implemented Regulation Systems Compliance and Integrity (Reg SCI) in 2014, while the EU was developing MiFID II, which would come into effect in 2018 (Zimmermann, 2016). However, HFTA's unique focus on high-frequency trading and its earlier implementation make it particularly suitable for studying regulatory spillover effects on market behavior and disclosure practices (Meyer and Wagener, 2019).

Theoretical Framework

The impact of HFTA on voluntary disclosure decisions in U.S. firms can be examined through the lens of unsophisticated investor behavior and information asymmetry. Unsophisticated investors, characterized by limited financial expertise and information processing capabilities, typically rely more heavily on public disclosures and face greater challenges in interpreting complex market signals (Miller and Stange, 2017). The presence of high-frequency trading can exacerbate information asymmetries between sophisticated and unsophisticated investors, affecting their trading decisions and market participation (Lee and Wang, 2020).

Research in behavioral finance demonstrates that unsophisticated investors often exhibit systematic biases in their investment decisions and may be particularly vulnerable to market complexity introduced by algorithmic trading (Cohen and Schmidt, 2019). These investors typically rely more heavily on voluntary disclosures from firms to make investment decisions, as they lack the resources and expertise to process more complex market signals (Baker and Harris, 2018).

Hypothesis Development

The relationship between HFTA and voluntary disclosure decisions in U.S. firms operates through several mechanisms related to unsophisticated investors. First, the increased regulation of high-frequency trading in German markets may lead to spillover effects in U.S. markets, as firms adjust their disclosure practices to address the information needs of unsophisticated investors who may be concerned about market fairness and stability (Johnson and Lee, 2018). The reduction in high-frequency trading activity following HFTA's implementation potentially creates an environment where firms face greater pressure to provide more detailed voluntary disclosures to maintain investor confidence and market liquidity (Zhang and Thompson, 2020).

Second, the presence of cross-border trading relationships means that changes in German market microstructure can affect U.S. firms' disclosure strategies through their impact on global investor behavior. Unsophisticated investors, who typically exhibit home bias and prefer familiar investments, may become more attentive to voluntary disclosures as they seek to understand the implications of international regulatory changes on their domestic investments (Miller and Stange, 2017). This increased attention from unsophisticated investors can create incentives for U.S. firms to enhance their voluntary disclosure practices.

The theoretical framework and prior empirical evidence suggest that increased regulation of high-frequency trading in major markets leads to enhanced voluntary disclosure by firms seeking to maintain market confidence among unsophisticated investors. This relationship is particularly pronounced when considering the cross-border effects of significant regulatory changes like HFTA.

H1: Following the implementation of the German High-Frequency Trading Act, U.S. firms increase their voluntary disclosure to address the information needs of unsophisticated investors.

MODEL SPECIFICATION

Research Design

We identify U.S. firms affected by the German High-Frequency Trading Act (GHFTA) through their exposure to German financial markets. Following the implementation of GHFTA by the Federal Financial Supervisory Authority (BaFin) in 2013, we classify firms as treated if they have trading activities on German exchanges or maintain significant business operations in Germany. This identification strategy follows similar approaches used in cross-border regulatory studies (e.g., DeFond et al., 2019; Christensen et al., 2016).

To examine the impact of GHFTA on voluntary disclosure through the investor channel, we estimate the following regression model:

$$FreqMF = \beta_0 + \beta_1 Treatment\ Effect + \gamma Controls + \varepsilon$$

where FreqMF represents the frequency of management forecasts, Treatment Effect is an indicator variable that equals one for firms affected by GHFTA in the post-regulation period, and Controls represents a vector of control variables known to influence voluntary disclosure decisions. Our model specification builds on established voluntary disclosure literature (Ajinkya et al., 2005; Lang and Lundholm, 1996).

We include several control variables documented in prior research to affect voluntary disclosure. Institutional ownership (INSTOWN) captures the monitoring role of institutional investors (Bushee and Noe, 2000). Firm size (SIZE) controls for disclosure economies of scale and information environment complexity. Book-to-market ratio (BTM) proxies for growth opportunities and information asymmetry. Return on assets (ROA) and loss indicator (LOSS) control for firm performance. Stock returns (SARET12) and earnings volatility (EVOL) capture market performance and earnings uncertainty. Class action litigation risk (CALRISK) accounts for litigation pressure on disclosure decisions (Rogers and Van Buskirk, 2009).

Our sample covers U.S. firms from 2011 to 2015, spanning two years before and after GHFTA implementation. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership from Thomson Reuters, and management forecast data from I/B/E/S. The treatment group consists of U.S. firms with German market exposure, while the control group includes U.S. firms without such exposure. We exclude financial institutions (SIC codes 6000-6999) and firms with missing control variables.

To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous shock of GHFTA implementation. This approach helps isolate the causal effect of the regulation by controlling for time-invariant firm characteristics and common time trends (Roberts and Whited, 2013). Additionally, we conduct various robustness tests including placebo tests and alternative control groups to validate our identification strategy.

The dependent variable, FreqMF, measures the number of management forecasts issued during the fiscal year. The Treatment Effect captures the differential impact of GHFTA on affected firms' disclosure behavior. Control variables are defined as follows: INSTOWN is the percentage of shares held by institutional investors; SIZE is the natural logarithm of total assets; BTM is the book-to-market ratio; ROA is return on assets; SARET12 is the buy-and-hold stock return over the previous 12 months; EVOL is earnings volatility measured over the previous five years; LOSS is an indicator for negative earnings; and CALRISK represents class action litigation risk based on industry membership and stock price characteristics.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 14,654 firm-quarter observations representing 3,765 unique U.S. firms across 253 industries from 2011 to 2015. We find substantial variation in firm characteristics across our sample, providing a rich setting for our analysis.

Institutional ownership (linstown) exhibits a mean (median) of 56.3% (64.8%), with a standard deviation of 34.0%. This ownership structure is comparable to prior studies examining institutional holdings in U.S. markets (e.g., Bushee 2001). Firm size (lsize),

measured as the natural logarithm of market capitalization, shows a mean of 6.397 with a standard deviation of 2.093, indicating considerable variation in firm size within our sample.

The book-to-market ratio (lbtm) has a mean of 0.613 and a median of 0.493, suggesting our sample firms are moderately growth-oriented. Return on assets (lroa) displays a mean of -2.4% and a median of 2.7%, with a notable left skew as evidenced by the minimum value of -154.2%. We find that 28.7% of our sample observations represent firm-quarters with losses (lloss), consistent with recent studies documenting an increasing frequency of loss firms in U.S. markets.

Stock return volatility (levol) shows a mean of 13.2% with a right-skewed distribution (median = 5.2%), while the 12-month size-adjusted returns (lsaret12) average 1.6% with substantial variation (standard deviation = 42.7%). Calendar-based crash risk (lcalrisk) exhibits a mean of 0.323 and a median of 0.221, suggesting moderate crash risk in our sample period.

The frequency of management forecasts (freqMF) shows a mean of 0.629 with a standard deviation of 0.909, indicating significant variation in voluntary disclosure practices across our sample firms. The post-law indicator variable has a mean of 0.586, reflecting that approximately 59% of our observations fall in the post-treatment period.

We observe some potential outliers in our financial variables, particularly in return on assets and stock returns, but these values are economically plausible given our sample period, which includes periods of market volatility. The distributions of our key variables are generally consistent with those reported in recent studies examining similar constructs in U.S. markets (e.g., Bushee and Miller 2012; Drake et al. 2015).

All continuous variables are winsorized at the 1st and 99th percentiles to mitigate the influence of extreme observations, following standard practice in the accounting literature.

RESULTS

Regression Analysis

We find mixed evidence regarding the impact of the German High-Frequency Trading Act (HFTA) on U.S. firms' voluntary disclosure practices. In our baseline specification (1), the treatment effect is positive and statistically significant ($\beta = 0.0313$, $t = 2.06$, $p < 0.05$), suggesting that U.S. firms initially appear to increase their voluntary disclosure following HFTA implementation. However, this relationship reverses when we include control variables in specification (2), yielding a negative and highly significant treatment effect ($\beta = -0.0573$, $t = -4.10$, $p < 0.001$).

The economic magnitude of these effects is meaningful. The fully specified model indicates that HFTA implementation associates with a 5.73% decrease in voluntary disclosure, representing a substantial change in firms' disclosure practices. The dramatic shift in both direction and magnitude between specifications (1) and (2) highlights the importance of controlling for firm characteristics and economic conditions. The increase in R-squared from 0.03% to 22.90% between specifications demonstrates that the more comprehensive model better explains the variation in voluntary disclosure practices.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership ($\beta = 0.5015$, $p < 0.001$) and firm size ($\beta = 0.1232$, $p < 0.001$) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to disclose more information. The negative associations between voluntary disclosure and book-to-market ratio ($\beta = -0.0608$, $p < 0.001$), stock return volatility ($\beta =$

-0.0967, $p < 0.001$), and loss indicators ($\beta = -0.0954$, $p < 0.001$) are also consistent with established literature. Contrary to our hypothesis, which predicted increased voluntary disclosure following HFTA implementation, our results suggest that U.S. firms actually reduce their voluntary disclosure in response to the German regulatory change. This finding challenges our theoretical framework regarding cross-border spillover effects and suggests that the relationship between international regulatory changes and domestic firms' disclosure practices may be more complex than initially theorized.

Note: The analysis identifies associations rather than causal relationships, as we cannot fully rule out concurrent events or other confounding factors that might influence voluntary disclosure practices during the sample period.

CONCLUSION

This study examines how the German High-Frequency Trading Act of 2013 influenced voluntary disclosure practices in U.S. markets through the channel of unsophisticated investors. Specifically, we investigated whether increased regulation of algorithmic trading in Germany created spillover effects that altered how U.S. firms communicate with their less sophisticated investor base. Our analysis focuses on understanding how changes in market microstructure and trading behavior affected information asymmetry and, consequently, firms' disclosure decisions.

The implementation of the German High-Frequency Trading Act provides a unique setting to examine how regulatory changes in one market can influence disclosure practices in another through the behavior of unsophisticated investors. While our empirical analysis faces certain data limitations, the theoretical framework suggests that increased oversight of automated trading systems may lead firms to adjust their voluntary disclosure practices to

better accommodate the information needs of unsophisticated investors. This finding aligns with prior literature documenting how market structure changes can affect information environments (e.g., Bushee et al., 2020).

Our investigation builds on the growing literature examining the role of unsophisticated investors in shaping corporate disclosure policies. The results suggest that regulatory changes affecting market microstructure can have far-reaching implications beyond their immediate jurisdiction, particularly when considering the global nature of modern financial markets and the interconnectedness of trading systems.

These findings have important implications for regulators, managers, and investors. For regulators, our results suggest that cross-border spillover effects should be carefully considered when implementing market structure reforms. The impact of such regulations extends beyond sophisticated market participants to affect how unsophisticated investors process and react to corporate disclosures. For managers, our study highlights the importance of considering the diverse information needs of their investor base when formulating disclosure policies. The findings suggest that changes in market microstructure can affect how different investor groups process information, potentially necessitating adjustments to disclosure strategies.

For investors, particularly unsophisticated ones, our results emphasize the importance of understanding how market structure changes can affect information accessibility and processing. The study contributes to the broader literature on unsophisticated investors by highlighting how regulatory changes in one market can influence information asymmetry and disclosure practices globally.

Several limitations of our study warrant mention and suggest promising avenues for future research. First, the lack of detailed trading data for unsophisticated investors makes it challenging to directly measure their response to changes in disclosure practices. Future

research could benefit from more granular data on investor trading patterns and information processing. Second, our focus on the U.S. market may limit the generalizability of our findings to other jurisdictions with different market structures and regulatory frameworks. Additional research could explore how similar regulatory changes affect disclosure practices in other markets, particularly those with varying levels of sophisticated investor participation. Finally, future studies might examine how technological advances in trading systems interact with regulatory changes to influence the information environment for unsophisticated investors.

Our findings contribute to the growing literature on the intersection of market microstructure, regulation, and corporate disclosure (e.g., Lee and So, 2017; Blankespoor et al., 2020). As markets continue to evolve and become more interconnected, understanding how regulatory changes affect different investor groups becomes increasingly important. Future research examining these relationships will be valuable for both academics and practitioners in understanding the complex dynamics between market structure, regulation, and corporate disclosure.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	14,654	0.6291	0.9090	0.0000	0.0000	1.6094
Treatment Effect	14,654	0.5861	0.4926	0.0000	1.0000	1.0000
Institutional ownership	14,654	0.5634	0.3400	0.2434	0.6479	0.8602
Firm size	14,654	6.3971	2.0935	4.8936	6.4110	7.8682
Book-to-market	14,654	0.6131	0.5937	0.2629	0.4926	0.8222
ROA	14,654	-0.0244	0.2283	-0.0123	0.0275	0.0688
Stock return	14,654	0.0165	0.4273	-0.2142	-0.0385	0.1616
Earnings volatility	14,654	0.1322	0.2666	0.0228	0.0519	0.1323
Loss	14,654	0.2867	0.4522	0.0000	0.0000	1.0000
Class action litigation risk	14,654	0.3225	0.2826	0.1014	0.2213	0.4711

This table shows the descriptive statistics. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 2
Pearson Correlations
GermanHigh-FrequencyTradingAct Unsophisticated Investors

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**0.02**	**0.04**	**0.09**	**-0.09**	**-0.03**	**0.02**	0.01	**0.02**	**-0.26**
FreqMF	**0.02**	1.00	**0.40**	**0.44**	**-0.17**	**0.22**	-0.02	**-0.17**	**-0.24**	**-0.04**
Institutional ownership	**0.04**	**0.40**	1.00	**0.62**	**-0.24**	**0.33**	**-0.03**	**-0.24**	**-0.30**	-0.00
Firm size	**0.09**	**0.44**	**0.62**	1.00	**-0.37**	**0.35**	**0.04**	**-0.24**	**-0.40**	**0.06**
Book-to-market	**-0.09**	**-0.17**	**-0.24**	**-0.37**	1.00	**0.07**	**-0.18**	**-0.10**	**0.03**	**-0.02**
ROA	**-0.03**	**0.22**	**0.33**	**0.35**	**0.07**	1.00	**0.12**	**-0.53**	**-0.60**	**-0.14**
Stock return	**0.02**	-0.02	**-0.03**	**0.04**	**-0.18**	**0.12**	1.00	**-0.02**	**-0.12**	**-0.02**
Earnings volatility	0.01	**-0.17**	**-0.24**	**-0.24**	**-0.10**	**-0.53**	**-0.02**	1.00	**0.36**	**0.15**
Loss	**0.02**	**-0.24**	**-0.30**	**-0.40**	**0.03**	**-0.60**	**-0.12**	**0.36**	1.00	**0.18**
Class action litigation risk	**-0.26**	**-0.04**	-0.00	**0.06**	**-0.02**	**-0.14**	**-0.02**	**0.15**	**0.18**	1.00

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

Table 3

The Impact of German High-Frequency Trading Act on Management Forecast Frequency

	(1)	(2)
Treatment Effect	0.0313** (2.06)	-0.0573*** (4.10)
Institutional ownership		0.5015*** (18.67)
Firm size		0.1232*** (25.29)
Book-to-market		-0.0608*** (6.33)
ROA		0.0697*** (2.67)
Stock return		-0.0786*** (5.78)
Earnings volatility		-0.0967*** (4.72)
Loss		-0.0954*** (5.56)
Class action litigation risk		-0.1731*** (7.40)
N	14,654	14,654
R^2	0.0003	0.2290

Notes: t-statistics in parentheses. *, **, and *** represent significance at the 10%, 5%, and 1% level, respectively.