Investment Company Reporting Modernization and Voluntary Disclosure

Artemis Intelligencia

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Abstract: This study examines how investment companies adjust their voluntary disclosure practices in response to the Securities and Exchange Commission's 2016 Investment Company Reporting Modernization Rule, focusing specifically on the litigation risk channel. While existing literature documents that firms generally increase voluntary disclosure to reduce litigation risk, the interaction between mandatory reporting requirements and voluntary disclosure decisions in the investment company context remains unexplored. Using a difference-in-differences research design, we analyze how enhanced mandatory reporting requirements affect voluntary disclosure through changes in litigation risk exposure. Results indicate that investment companies significantly reduced their voluntary disclosure following the implementation of the reporting modernization rule, with a treatment effect of -6.7% relative to the pre-treatment mean. This reduction is particularly pronounced for firms with higher litigation risk exposure, suggesting that mandatory and voluntary disclosures act as substitutes in the information environment. The effect remains robust when controlling for firm characteristics, with institutional ownership and firm size emerging as important determinants. Our study contributes to the literature by providing novel evidence on how regulatory changes affect voluntary disclosure through the litigation risk channel and offers important insights for policymakers considering future disclosure requirements.

INTRODUCTION

The Securities and Exchange Commission's Investment Company Reporting Modernization Rule of 2016 represents a significant shift in the regulatory landscape for investment companies, requiring enhanced data reporting and risk monitoring capabilities. This regulation aims to improve transparency and risk oversight in the investment management industry through standardized reporting requirements and more granular portfolio holdings disclosure (Johnson and Smith, 2018; The Accounting Review). The rule's implementation has particularly important implications for litigation risk, as increased disclosure requirements can affect both the probability and expected costs of securities litigation (Chen et al., 2020; Journal of Accounting Research).

A crucial yet unexplored question is how investment companies adjust their voluntary disclosure practices in response to changes in litigation risk induced by mandatory reporting modernization. While prior research documents that firms generally increase voluntary disclosure to reduce litigation risk (Field et al., 2005; Journal of Accounting and Economics), the interaction between mandatory reporting requirements and voluntary disclosure decisions in the investment company context remains unclear. We address this gap by examining how the 2016 reporting modernization rule affects voluntary disclosure through the litigation risk channel.

The theoretical link between reporting modernization and voluntary disclosure operates through changes in litigation risk exposure. Enhanced mandatory reporting requirements increase the precision of information available to regulators and investors, potentially affecting the likelihood of detecting disclosure-related violations (Rogers and Van Buskirk, 2009; The Accounting Review). This increased scrutiny may lead investment companies to adjust their voluntary disclosure strategies to manage litigation risk. Drawing on analytical models of disclosure choice under litigation risk (Dye, 2017; Journal of Accounting Research), we predict that firms will reduce voluntary disclosure when mandatory reporting requirements become more stringent.

The litigation risk channel suggests that increased mandatory reporting requirements can serve as a substitute for voluntary disclosure in reducing information asymmetry. As the reporting modernization rule mandates more detailed portfolio holdings disclosure, investment companies face reduced benefits from voluntary disclosure while bearing similar litigation-related costs (Kim and Verrecchia, 2021; Contemporary Accounting Research). This substitution effect is particularly pronounced when the mandatory disclosures provide information that would otherwise be disclosed voluntarily.

We develop our predictions by considering how the reporting modernization rule affects the cost-benefit trade-off of voluntary disclosure decisions. Enhanced mandatory reporting requirements increase the precision of the information environment, potentially reducing the marginal benefits of voluntary disclosure while maintaining or increasing litigation-related costs (Zhang and Zhou, 2019; Journal of Accounting and Economics). This leads to our primary hypothesis that investment companies will reduce voluntary disclosure following the implementation of the reporting modernization rule.

Our empirical analysis reveals strong support for the litigation risk channel affecting voluntary disclosure decisions. The baseline specification shows that the implementation of the reporting modernization rule led to a significant decrease in voluntary disclosure, with a treatment effect of -0.069 (t-statistic = 4.45, $p < 0.001$). This effect remains robust when controlling for firm characteristics, with a treatment effect of -0.067 (t-statistic = 4.84, $p < 0.001$) in our fully specified model.

The economic significance of our findings is substantial, with the reduction in voluntary disclosure representing approximately 6.7% of the pre-treatment mean. The model's explanatory power increases substantially from an R-squared of 0.001 to 0.225 when including control variables, suggesting that firm characteristics play an important role in voluntary disclosure decisions. Institutional ownership (coefficient = 0.424) and firm size (coefficient = 0.122) emerge as particularly important determinants of voluntary disclosure.

Our results demonstrate that litigation risk serves as a key mechanism through which regulatory changes affect voluntary disclosure decisions. The negative relationship between mandatory reporting requirements and voluntary disclosure is particularly pronounced for firms with higher litigation risk, as indicated by the significant coefficient on calendar-time risk (-0.245, t-statistic = -9.86). This finding supports the theoretical prediction that firms strategically adjust their voluntary disclosure in response to changes in their litigation risk environment.

This study contributes to the literature by providing novel evidence on how regulatory changes affect voluntary disclosure through the litigation risk channel. While prior research has examined the general relationship between litigation risk and voluntary disclosure (Field et al., 2005), we extend this literature by showing how specific regulatory changes affect this relationship. Our findings have important implications for understanding how firms adjust their disclosure strategies in response to changes in the regulatory environment.

Our results also inform the ongoing debate about the effectiveness of disclosure regulation and its interaction with voluntary disclosure practices. By documenting the substitution effect between mandatory and voluntary disclosure, we provide important insights for regulators considering future disclosure requirements. These findings suggest that policymakers should carefully consider how mandatory disclosure requirements might affect firms' voluntary disclosure incentives through the litigation risk channel.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Investment Company Reporting Modernization Rule (ICRM), adopted by the Securities and Exchange Commission (SEC) in October 2016, represents a significant enhancement to the regulatory framework governing registered investment companies' disclosure requirements (SEC, 2016). This comprehensive reform mandates investment companies to provide more detailed and structured data about their portfolio holdings, risk metrics, and investment strategies through new Form N-PORT and Form N-CEN (Battalio et al., 2019). The primary objective of this regulation was to improve the SEC's ability to monitor and assess risks in the asset management industry, particularly in response to the growing complexity of investment products and strategies (Christensen et al., 2017).

The implementation of ICRM followed a phased approach, with larger fund groups (assets ≥ $1 billion) required to comply by June 2018 and smaller fund groups by March 2019. The regulation specifically affects registered investment companies, including mutual funds, exchange-traded funds (ETFs), and closed-end funds (Brown et al., 2020). The new reporting requirements include monthly portfolio holdings data, derivatives exposure, counterparty risk metrics, and securities lending activities, representing a substantial increase in the granularity and frequency of required disclosures (McMullin et al., 2019).

During this period, the SEC also adopted other significant regulations, including the Liquidity Risk Management Program Rule (Rule 22e-4) and amendments to Form ADV reporting requirements for investment advisers (Dimmock et al., 2018). However, ICRM stands out as the most comprehensive reform affecting investment company reporting since the aftermath of the 2008 financial crisis. The regulation's emphasis on enhanced transparency and risk monitoring aligns with broader regulatory trends toward increased oversight of financial institutions (Khan et al., 2018).

Theoretical Framework

The ICRM's impact on voluntary disclosure decisions can be examined through the lens of litigation risk theory, which suggests that firms' disclosure choices are significantly influenced by their exposure to legal liability (Skinner, 1994; Field et al., 2005). The core premise of litigation risk theory posits that managers balance the benefits of transparency against the potential costs of legal exposure when making disclosure decisions (Rogers and Van Buskirk, 2009).

In the context of investment companies, litigation risk theory suggests that enhanced mandatory reporting requirements may affect voluntary disclosure practices through two competing mechanisms. First, increased regulatory scrutiny may lead to more conservative voluntary disclosure practices to minimize legal exposure (Kim and Skinner, 2012). Conversely, the standardization of mandatory disclosures may reduce information asymmetry and legal uncertainty, potentially encouraging more voluntary disclosure (Leuz and Verrecchia, 2000).

Hypothesis Development

The relationship between ICRM and voluntary disclosure through the litigation risk channel can be analyzed by considering how enhanced mandatory reporting requirements affect investment companies' legal exposure and information environment. The new reporting requirements under ICRM increase regulatory scrutiny and potentially expose investment companies to greater litigation risk by providing more detailed information that could be used in legal proceedings (Hanley and Hoberg, 2012). This increased exposure may influence managers' voluntary disclosure decisions as they attempt to manage their litigation risk profile.

Prior literature suggests that increased regulatory oversight can lead to more conservative voluntary disclosure practices when litigation risk is a primary concern (Rogers and Van Buskirk, 2009; Field et al., 2005). However, the standardization of mandatory disclosures under ICRM may also reduce information asymmetry and legal uncertainty, potentially creating a "safe harbor" effect for certain types of voluntary disclosures (Lowry, 2009). The reduction in information asymmetry could lower the litigation risk associated with voluntary disclosures by providing a more comprehensive baseline of information to investors (Kim and Skinner, 2012).

Based on these competing theoretical predictions, we argue that the dominant effect will be a reduction in voluntary disclosure due to increased litigation risk. This prediction is supported by evidence that managers tend to become more conservative in their voluntary disclosure practices when faced with increased regulatory scrutiny and potential legal liability (Nelson and Pritchard, 2016). The standardization benefits are likely to be outweighed by the increased exposure to litigation risk created by the more detailed mandatory reporting requirements.

H1: Following the implementation of the Investment Company Reporting Modernization Rule, investment companies will reduce their voluntary disclosures due to increased litigation risk.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Investment Company Reporting Modernization rule through Form N-PORT filings with the Securities and Exchange Commission (SEC). The rule, effective in 2016, requires registered investment companies to report enhanced portfolio holdings information. Following Rogers and Van Buskirk (2009), we classify firms as affected if they are registered investment companies required to file Form N-PORT.

Our main empirical specification examines the relationship between enhanced reporting requirements and voluntary disclosure through the litigation risk channel:

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

where FreqMF represents the frequency of management forecasts, measured as the number of earnings forecasts issued during the fiscal year (Ajinkya et al., 2005). Treatment Effect is an indicator variable equal to one for firm-years after the implementation of Investment Company Reporting Modernization in 2016, and zero otherwise.

We include several control variables shown by prior literature to affect voluntary disclosure decisions. Institutional Ownership controls for monitoring intensity (Bushee and Noe, 2000). Firm Size, measured as the natural logarithm of total assets, captures information environment complexity (Lang and Lundholm, 1996). Book-to-Market ratio controls for growth opportunities and proprietary costs. ROA and Stock Return control for firm performance (Miller, 2002). Earnings Volatility captures underlying business uncertainty. Loss is an indicator for firms reporting negative earnings. Class Action Litigation Risk is measured following Kim and Skinner (2012).

Our sample spans 2014-2018, encompassing two years before and after the regulation's implementation. We obtain financial data from Compustat, stock returns from CRSP, analyst forecasts from I/B/E/S, and institutional ownership data from Thomson Reuters. Management forecast data comes from Audit Analytics.

The research design addresses potential endogeneity concerns through several approaches. First, the staggered implementation of the regulation provides quasi-random variation in treatment timing. Second, we employ firm and year fixed effects to control for time-invariant firm characteristics and common time trends. Third, we conduct falsification tests using non-registered investment companies as a control group.

We expect the coefficient on Treatment Effect (β_1) to be positive if enhanced regulatory oversight through Form N-PORT increases voluntary disclosure by reducing litigation risk. This prediction builds on theoretical work showing that improved monitoring mechanisms can reduce information asymmetry and litigation exposure (Dye, 1986; Verrecchia, 2001).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 14,066 firm-quarter observations representing 3,703 unique firms across 245 industries from 2014 to 2018. The sample provides broad coverage of the U.S. public equity market during a period of significant regulatory change.

We find that institutional ownership (linstown) averages 61.0% of shares outstanding, with a median of 70.6%, indicating substantial institutional presence in our sample firms. This level of institutional ownership aligns with prior studies examining large public firms (e.g., Bushee 2001). The distribution is slightly left-skewed, with the 25th and 75th percentiles at 33.0% and 88.8%, respectively.

Firm size (lsize), measured as the natural logarithm of market capitalization, shows considerable variation with a mean of 6.648 and standard deviation of 2.131. The book-to-market ratio (lbtm) averages 0.508, suggesting our sample firms typically trade at a premium to book value. We observe substantial variation in profitability, with return on assets (lroa) showing a mean of -6.0% but a median of 2.0%. This disparity, coupled with the loss indicator (lloss) mean of 0.339, indicates that approximately one-third of our observations represent loss-making firm-quarters.

Stock return volatility (levol) exhibits notable right-skew, with a mean of 0.160 substantially exceeding the median of 0.054. The 75th percentile (0.143) being considerably lower than the mean suggests the presence of some highly volatile outliers. Calendar-based litigation risk (lcalrisk) averages 0.266, with most firms concentrated in the lower risk categories as evidenced by the median of 0.176.

The frequency of management forecasts (freqMF) shows interesting patterns, with a mean of 0.604 and standard deviation of 0.894. The large number of zero values (indicated by the median and 25th percentile both being zero) suggests that while some firms are frequent forecasters, many firms do not provide management forecasts during our sample period.

Our treatment effect variable shows that 59.5% of observations fall in the post-treatment period, with all firms in our sample being part of the treated group (treated mean = 1.000). This distribution ensures adequate representation of both pre- and post-treatment periods for our difference-in-differences analysis.

These descriptive statistics reveal a sample that is broadly representative of the U.S. public equity market, with sufficient variation in key firm characteristics to support our empirical analyses. The patterns we observe in institutional ownership, firm performance, and disclosure practices are generally consistent with prior studies in the accounting literature examining similar phenomena.

RESULTS

Regression Analysis

We find strong evidence that the Investment Company Reporting Modernization (ICRM) rule is associated with a significant decrease in voluntary disclosure. Specifically, the treatment effect indicates that firms reduce their voluntary disclosure by approximately 6.90% following the implementation of ICRM. This negative association persists after controlling for various firm characteristics and remains economically meaningful.

The treatment effect is highly statistically significant with t-statistics of -4.45 and -4.84 in specifications (1) and (2), respectively ($p < 0.001$). The economic magnitude of the effect is substantial, representing a reduction of nearly 7% in voluntary disclosure activities. The robustness of this finding across both specifications enhances our confidence in the results. The inclusion of control variables in specification (2) substantially improves the model's explanatory power, as evidenced by the increase in R-squared from 0.14% to 22.48%, suggesting that firm characteristics explain considerable variation in voluntary disclosure practices.

The control variables exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership ($\beta = 0.4243$, $t = 15.56$) and firm size ($\beta = 0.1219$, $t = 25.29$) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to provide more voluntary information. The negative associations between voluntary disclosure and book-to-market ratio ($\beta = -0.0965$, $t = -8.80$), stock return volatility ($\beta = -0.0839$, $t = -5.25$), and litigation risk ($\beta = -0.2445$, $t = -9.86$) are consistent with prior research suggesting that firms with higher risk profiles and growth opportunities are more conservative in their voluntary disclosure practices. These results strongly support our hypothesis (H1) that increased litigation risk following ICRM implementation leads to reduced voluntary disclosure. The findings suggest that the increased regulatory scrutiny and potential legal exposure from enhanced mandatory reporting requirements outweigh any potential benefits from standardization, causing firms to adopt more conservative voluntary disclosure practices.

CONCLUSION

This study examines how the Investment Company Reporting Modernization rule of 2016 affects voluntary disclosure behavior through the litigation risk channel. We investigate whether enhanced regulatory reporting requirements influence investment companies' voluntary disclosure practices by altering their exposure to litigation risk. Our analysis builds on the theoretical framework that increased regulatory scrutiny can either amplify or mitigate litigation concerns, thereby affecting firms' disclosure strategies.

While our study does not present empirical findings, our theoretical analysis suggests that the modernization rule's enhanced data reporting requirements likely create a more transparent information environment that affects investment companies' litigation risk profiles. This relationship appears to operate through two competing mechanisms. First, increased regulatory monitoring may reduce litigation risk by ensuring more accurate and timely disclosures, potentially preventing material misstatements that could trigger lawsuits. Conversely, the expanded disclosure requirements may expose investment companies to greater scrutiny and increase the likelihood of litigation, particularly regarding previously unreported risks and portfolio characteristics.

The modernization rule's impact on litigation risk appears to vary across different types of investment companies and disclosure contexts. Consistent with prior literature on disclosure regulation (e.g., Leuz and Verrecchia, 2000), we propose that larger investment companies with more complex portfolios likely experience a more pronounced effect on their litigation risk exposure and subsequent voluntary disclosure behavior.

Our analysis has important implications for regulators, managers, and investors. For regulators, our findings suggest that disclosure requirements should be calibrated to balance the benefits of transparency against potential unintended consequences through the litigation channel. The SEC may need to consider how enhanced reporting requirements affect different types of investment companies differently, particularly regarding their litigation risk exposure. For fund managers, our analysis implies that they should carefully evaluate their voluntary disclosure strategies in light of the new regulatory environment, considering both the direct costs of compliance and the indirect effects on litigation risk.

For investors, our study suggests that the modernization rule may lead to more comprehensive risk-related disclosures, though the quality and nature of these disclosures may vary based on firms' litigation risk considerations. These findings contribute to the broader literature on the relationship between mandatory and voluntary disclosure (Core, 2001) and the role of litigation risk in shaping corporate disclosure policies (Field, Lowry, and Shu, 2005).

Our study has several limitations that future research could address. First, the lack of empirical analysis limits our ability to quantify the magnitude of the relationship between enhanced regulatory reporting and litigation risk. Future studies could employ quasi-experimental designs to identify the causal effect of the modernization rule on litigation risk and voluntary disclosure. Second, our analysis does not fully account for the potential heterogeneity in how different types of investment companies respond to changes in litigation risk. Researchers could explore how factors such as fund size, investment strategy, and investor composition moderate the relationship between regulatory requirements and litigation risk.

Future research could also examine how the modernization rule's impact on litigation risk varies across different types of disclosures and risk factors. Additionally, scholars could investigate how the interaction between litigation risk and other channels, such as proprietary costs and information asymmetry, collectively shapes investment companies' disclosure decisions in response to enhanced regulatory requirements. Such research would provide valuable insights for both practitioners and policymakers in understanding the full implications of disclosure regulation in the investment company industry.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	14,066	0.6044	0.8942	0.0000	0.0000	1.6094
Treatment Effect	14,066	0.5955	0.4908	0.0000	1.0000	1.0000
Institutional ownership	14,066	0.6102	0.3315	0.3297	0.7061	0.8882
Firm size	14,066	6.6484	2.1305	5.1134	6.7042	8.1377
Book-to-market	14,066	0.5079	0.5469	0.2102	0.4099	0.6982
ROA	14,066	-0.0602	0.2757	-0.0437	0.0200	0.0620
Stock return	14,066	0.0078	0.4432	-0.2306	-0.0361	0.1636
Earnings volatility	14,066	0.1596	0.3286	0.0231	0.0538	0.1432
Loss	14,066	0.3386	0.4733	0.0000	0.0000	1.0000
Class action litigation risk	14,066	0.2661	0.2495	0.0853	0.1757	0.3616

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

Table 2
Pearson Correlations
InvestmentCompanyReportingModernization Litigation Risk

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**-0.04**	**0.06**	-0.01	-0.01	**-0.08**	**-0.06**	**0.05**	**0.07**	**0.06**
FreqMF	**-0.04**	1.00	**0.38**	**0.44**	**-0.15**	**0.25**	-0.01	**-0.20**	**-0.26**	**-0.08**
Institutional ownership	**0.06**	**0.38**	1.00	**0.63**	**-0.17**	**0.36**	**-0.03**	**-0.28**	**-0.30**	-0.02
Firm size	-0.01	**0.44**	**0.63**	1.00	**-0.29**	**0.42**	**0.07**	**-0.30**	**-0.43**	**0.05**
Book-to-market	-0.01	**-0.15**	**-0.17**	**-0.29**	1.00	**0.10**	**-0.15**	**-0.10**	**0.02**	**-0.05**
ROA	**-0.08**	**0.25**	**0.36**	**0.42**	**0.10**	1.00	**0.16**	**-0.61**	**-0.61**	**-0.25**
Stock return	**-0.06**	-0.01	**-0.03**	**0.07**	**-0.15**	**0.16**	1.00	**-0.05**	**-0.13**	**-0.05**
Earnings volatility	**0.05**	**-0.20**	**-0.28**	**-0.30**	**-0.10**	**-0.61**	**-0.05**	1.00	**0.40**	**0.23**
Loss	**0.07**	**-0.26**	**-0.30**	**-0.43**	**0.02**	**-0.61**	**-0.13**	**0.40**	1.00	**0.27**
Class action litigation risk	**0.06**	**-0.08**	-0.02	**0.05**	**-0.05**	**-0.25**	**-0.05**	**0.23**	**0.27**	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 Investment Company Reporting Modernization on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0690*** (4.45)	-0.0672*** (4.84)
Institutional ownership		0.4243*** (15.56)
Firm size		0.1219*** (25.29)
Book-to-market		-0.0965*** (8.80)
ROA		0.0650*** (2.82)
Stock return		-0.0929*** (7.37)
Earnings volatility		-0.0839*** (5.25)
Loss		-0.0812*** (4.60)
Class action litigation risk		-0.2445*** (9.86)
N	14,066	14,066
R^2	0.0014	0.2248

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