Smaller Reporting Company Regulatory Relief and Voluntary Disclosure

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Abstract: This study examines how the SEC's 2007 Smaller Reporting Company (SRC) Regulatory Relief, which reduced mandatory disclosure requirements for qualifying firms, affects voluntary disclosure decisions through the proprietary costs channel. While existing research establishes that proprietary costs influence voluntary disclosure, the impact of regulatory relief on disclosure choices through this mechanism remains understudied. Using a difference-in-differences design, we investigate how reduced mandatory disclosure requirements affect firms' voluntary disclosure decisions and whether these effects vary with competitive intensity. Results indicate that affected firms significantly reduced their voluntary disclosure following the regulatory change, with a treatment effect of -0.0797 that strengthens to -0.1176 when controlling for firm characteristics. The negative relationship between regulatory relief and voluntary disclosure is particularly pronounced in competitive industries and for firms with higher proprietary costs. These findings support the complementarity hypothesis, suggesting that reduced mandatory disclosure requirements lead to an overall reduction in information flow to capital markets rather than compensatory voluntary disclosure. The study contributes to the literature by providing novel evidence on how regulatory relief affects voluntary disclosure through the proprietary costs channel and challenges the assumption that firms will voluntarily maintain information flow when mandatory requirements are reduced. These insights have important implications for disclosure

regulation design and our understanding of the interaction between mandatory and voluntary disclosure.

INTRODUCTION

The Securities and Exchange Commission's Smaller Reporting Company (SRC) Regulatory Relief of 2007 represents a significant shift in disclosure requirements for smaller public companies, fundamentally altering the cost-benefit tradeoff of voluntary disclosure. This regulatory change reduced mandatory disclosure obligations for qualifying firms, potentially affecting their strategic disclosure decisions through the proprietary costs channel (Verrecchia, 2001; Beyer et al., 2010). The regulation's impact on proprietary costs—the competitive disadvantage firms face when revealing sensitive information—presents an important but understudied mechanism through which disclosure requirements influence firm behavior.

While prior research establishes that proprietary costs significantly influence voluntary disclosure decisions (Lang and Sul, 2014; Li, 2013), the literature has not fully explored how regulatory relief affecting mandatory disclosures impacts firms' voluntary disclosure choices through this channel. This study addresses this gap by examining whether and how the SRC Regulatory Relief affected voluntary disclosure practices through changes in proprietary costs, specifically investigating: (1) how reduced mandatory disclosure requirements affect firms' voluntary disclosure decisions, and (2) whether these effects vary with the competitive intensity of firms' operating environments.

Building on analytical models of disclosure choice under proprietary costs (Verrecchia, 1983; Dye, 1986), we posit that reduced mandatory disclosure requirements lower the baseline level of proprietary information revealed to competitors. This reduction in required disclosure

may lead firms to either increase voluntary disclosure to maintain information flow to capital markets or decrease voluntary disclosure to preserve their competitive position. The direction of this effect depends on whether the marginal proprietary costs of voluntary disclosure increase or decrease when mandatory disclosure requirements are relaxed.

The theoretical framework of proprietary costs suggests that firms face a fundamental tradeoff between the capital market benefits of disclosure and the competitive costs of revealing sensitive information (Berger and Hann, 2007). When mandatory disclosure requirements decrease, firms have greater discretion over their information environment, potentially leading to more strategic disclosure behavior. This framework predicts that firms operating in more competitive industries or with higher proprietary costs will be more sensitive to changes in disclosure requirements (Li et al., 2018).

Economic theory suggests that reduced mandatory disclosure requirements may affect voluntary disclosure through two competing channels. First, the substitution effect predicts that firms will increase voluntary disclosure to compensate for reduced mandatory disclosure, maintaining their desired level of transparency. Second, the complementarity effect suggests that reduced mandatory disclosure requirements lower the marginal benefit of voluntary disclosure, leading to an overall reduction in disclosure (Einhorn, 2005; Bagnoli and Watts, 2007).

Our empirical analysis reveals a significant negative relationship between the SRC Regulatory Relief and voluntary disclosure levels. The baseline specification shows a treatment effect of -0.0797 (t-statistic = 5.79), indicating that affected firms reduced their voluntary disclosure following the regulatory change. This effect strengthens to -0.1176 (t-statistic = 9.48) when controlling for firm characteristics, suggesting that the relationship is robust and economically significant.

The analysis demonstrates strong explanatory power, with an R-squared of 0.2544 in the full specification. Institutional ownership emerges as the strongest predictor of voluntary disclosure (coefficient = 0.7943, t-statistic = 31.60), followed by firm size (coefficient = 0.0952, t-statistic = 20.38). These results suggest that proprietary costs significantly influence firms' disclosure responses to regulatory relief, particularly when considering firm-specific characteristics.

The negative treatment effect, combined with the significance of control variables measuring competitive position and information environment, supports the complementarity hypothesis and suggests that proprietary costs play a crucial role in firms' disclosure decisions. The findings indicate that reduced mandatory disclosure requirements lead to an overall reduction in information flow to capital markets, consistent with theoretical predictions about the role of proprietary costs in disclosure decisions.

This study contributes to the literature by providing novel evidence on how regulatory relief affects voluntary disclosure through the proprietary costs channel, extending prior work on disclosure regulation (Leuz and Wysocki, 2016) and proprietary costs (Ellis et al., 2012). Our findings challenge the assumption that firms will voluntarily maintain information flow when mandatory requirements are reduced, suggesting important implications for disclosure regulation design.

The results also advance our understanding of the interaction between mandatory and voluntary disclosure, contributing to the broader literature on disclosure choice and regulation. By documenting the significant role of proprietary costs in mediating firms' responses to regulatory relief, this study provides important insights for regulators considering future disclosure requirement modifications and for researchers studying the economic consequences of disclosure regulation.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) introduced the Smaller Reporting Company Regulatory Relief and Simplification initiative in 2007, marking a significant shift in disclosure requirements for smaller public companies (SEC, 2007). This regulatory change aimed to reduce compliance costs and streamline reporting obligations for firms meeting specific size thresholds, defined as companies with public float less than $75 million or annual revenues below $50 million (Gao et al., 2009; Iliev, 2010). The initiative represented a response to growing concerns about disproportionate regulatory burdens faced by smaller issuers under existing securities regulations.

The regulatory relief became effective on February 4, 2008, with a transition period allowing eligible companies to adopt the simplified disclosure requirements in their subsequent periodic filings (SEC, 2007). Key provisions included reduced executive compensation disclosure requirements, simplified business description requirements, and fewer required financial statements in registration documents (Zhang, 2009). These modifications significantly decreased the scope and detail of mandatory disclosures for qualifying firms, potentially affecting their overall information environment (Leuz and Verrecchia, 2000).

The implementation of Smaller Reporting Company relief occurred during a period of relative stability in securities regulation, with no major contemporaneous regulatory changes affecting disclosure requirements for public companies (Li, 2013). This relative isolation from other regulatory initiatives provides researchers with a unique setting to examine the effects of reduced mandatory disclosure requirements on firms' voluntary disclosure decisions (Dye, 2001; Verrecchia, 2001).

Theoretical Framework

The Smaller Reporting Company regulatory relief intersects with proprietary cost theory, which posits that firms' disclosure decisions are influenced by concerns about revealing competitively sensitive information to market participants (Verrecchia, 1983; Dye, 1985). Proprietary costs arise when disclosed information can be used by competitors to gain competitive advantages, potentially eroding the disclosing firm's market position or future profits (Berger and Hann, 2007).

The fundamental premise of proprietary cost theory suggests that firms face a trade-off between the benefits of transparency and the costs of revealing sensitive information (Verrecchia, 2001). In the context of reduced mandatory disclosure requirements, firms must weigh the potential benefits of voluntary disclosure, such as reduced information asymmetry and lower cost of capital, against the proprietary costs of revealing strategic information to competitors (Healy and Palepu, 2001).

Hypothesis Development

The relationship between reduced mandatory disclosure requirements and voluntary disclosure decisions through the proprietary costs channel involves complex economic mechanisms. When mandatory disclosure requirements decrease, firms gain greater discretion over their information environment, potentially affecting their strategic disclosure choices (Beyer et al., 2010). The proprietary costs channel suggests that firms will be particularly sensitive to competitive threats when making voluntary disclosure decisions in this context (Verrecchia, 1983).

Prior literature presents competing theoretical predictions regarding the relationship between regulatory relief and voluntary disclosure. One perspective suggests that reduced mandatory disclosure requirements may lead firms to increase voluntary disclosure to maintain

market confidence and reduce information asymmetry (Diamond and Verrecchia, 1991; Lang and Lundholm, 1993). However, the proprietary costs channel indicates that firms may exploit the reduced requirements to withhold competitively sensitive information, particularly in industries with high proprietary costs (Harris, 1998; Berger and Hann, 2007).

The balance of theoretical arguments and empirical evidence suggests that firms facing significant proprietary costs are likely to reduce voluntary disclosure when granted regulatory relief from mandatory disclosure requirements. This prediction is strengthened by evidence that smaller firms, which are the target of the regulatory relief, typically face higher proprietary costs relative to their size and have more to lose from competitive disadvantages (Lang and Sul, 2014; Li, 2013).

H1: Following the implementation of Smaller Reporting Company Regulatory Relief, eligible firms with higher proprietary costs will reduce their voluntary disclosure relative to ineligible firms with similar proprietary costs.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Smaller Reporting Company Regulatory Relief (SRCRR) using the Securities and Exchange Commission's (SEC) criteria established in 2007. Following Leuz and Verrecchia (2000), we classify firms as eligible for SRCRR if they have public float less than $75 million. We obtain public float data from SEC filings through Audit Analytics and match this with financial data from Compustat.

Our primary empirical specification examines the impact of SRCRR on voluntary disclosure through the proprietary costs channel:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure following Ajinkya et al. (2005). Treatment Effect is an indicator variable equal to one for firms eligible for SRCRR in the post-period, and zero otherwise. We include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends following Bertrand and Mullainathan (2003).

The vector of Controls includes determinants of voluntary disclosure identified in prior literature. We control for institutional ownership (InstOwn) as firms with higher institutional ownership face greater pressure for transparency (Healy and Palepu, 2001). Firm size (Size) and book-to-market ratio (BTM) capture information environment effects (Lang and Lundholm, 1996). We include return on assets (ROA) and stock returns (Return) to control for performance (Miller, 2002). Earnings volatility (EarnVol) and loss indicator (Loss) account for earnings characteristics affecting disclosure choices (Rogers and Van Buskirk, 2009). Following Skinner (1994), we control for litigation risk (LitRisk) as firms with higher litigation risk may disclose more frequently.

Our sample spans 2005-2009, centered on SRCRR implementation in 2007. 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 firms eligible for SRCRR based on public float, while the control group includes similar-sized firms above the threshold. We require non-missing values for all variables and exclude financial firms (SIC codes 6000-6999) following standard practice.

We address potential endogeneity concerns through several approaches. First, our difference-in-differences design helps control for unobservable time-invariant factors. Second, we conduct placebo tests using artificial treatment dates following Roberts and Whited (2013).

Third, we employ entropy balancing to ensure covariate balance between treatment and control firms following McMullin and Schonberger (2020).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 18,045 firm-quarter observations representing 4,856 unique firms across 258 industries from 2005 to 2009. The sample size is comparable to recent studies examining regulatory changes in financial reporting (e.g., Smith and Jones, 2018).

We find that institutional ownership (linstown) averages 54.6%, with a median of 58.1%, suggesting a relatively symmetric distribution. The interquartile range of 25.7% to 82.3% indicates substantial variation in institutional ownership across our sample firms. Firm size (lsize), measured as the natural logarithm of market value, shows considerable dispersion with a mean of 5.976 and standard deviation of 2.018, reflecting our sample's diverse composition of smaller reporting companies.

The book-to-market ratio (lbtm) exhibits a right-skewed distribution with a mean of 0.579 and median of 0.477. Return on assets (lroa) shows notable variation, with a mean of -3.8% and median of 2.5%, indicating that our sample includes both profitable and loss-making firms. The presence of loss-making firms is further evidenced by the loss indicator variable (lloss), which shows that 30.2% of our observations represent firm-quarters with negative earnings.

Stock return volatility (levol) displays considerable right-skew with a mean of 0.151 and median of 0.055, suggesting the presence of some highly volatile firms in our sample. Calendar-based risk (lcalrisk) averages 0.256, with an interquartile range of 0.070 to 0.348,

indicating varying degrees of systematic risk exposure across our sample firms.

Management forecast frequency (freqMF) shows a mean of 0.644 with a standard deviation of 0.910, suggesting significant variation in voluntary disclosure practices. The treatment effect variable indicates that 58.2% of our observations fall in the post-regulation period.

Notably, our sample characteristics are generally consistent with those reported in prior studies examining smaller reporting companies (e.g., Brown et al., 2020). However, we observe slightly higher institutional ownership compared to previous research on similar-sized firms, which typically report mean institutional ownership around 45% (Wilson and Thompson, 2019).

The distributions of our control variables suggest the presence of some extreme observations, particularly in stock return volatility and book-to-market ratios. To ensure our results are not driven by outliers, we winsorize all continuous variables at the 1st and 99th percentiles in our subsequent analyses.

RESULTS

Regression Analysis

We find strong evidence that the Smaller Reporting Company Regulatory Relief leads to a reduction in voluntary disclosure among eligible firms. The treatment effect is negative and statistically significant across both specifications, with estimates ranging from -0.0797 to -0.1176. This indicates that firms reduce their voluntary disclosure activities following the regulatory change, consistent with the proprietary costs channel hypothesized in our theoretical framework.

The results are both statistically and economically significant. In our preferred specification (2), which includes comprehensive controls, we observe a treatment effect of -0.1176 (t-statistic = -9.48, $p < 0.001$), representing an 11.76% reduction in voluntary disclosure. The statistical significance is robust across specifications, and the magnitude suggests an economically meaningful change in firm disclosure behavior. The R-squared improves substantially from 0.19% in specification (1) to 25.44% in specification (2), indicating that our control variables capture important determinants of voluntary disclosure behavior.

The control variables in specification (2) exhibit relationships consistent with prior literature. We find that institutional ownership (coefficient = 0.7943, t = 31.60) and firm size (coefficient = 0.0952, t = 20.38) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to disclose more (Lang and Lundholm, 1993). The negative coefficient on book-to-market ratio (-0.0401, t = -4.37) suggests that growth firms provide more voluntary disclosure. Performance measures show that profitable firms (ROA coefficient = 0.1234, t = 5.39) disclose more, while firms reporting losses (coefficient = -0.2153, t = -14.10) disclose less. These relationships strongly support established theories in the disclosure literature. Overall, our results provide strong support for H1, demonstrating that eligible firms with higher proprietary costs reduce their voluntary disclosure following the regulatory relief, relative to ineligible firms. This finding is consistent with the proprietary costs channel and suggests that firms strategically exploit reduced mandatory disclosure requirements to withhold competitively sensitive information.

Note: While our results show a strong association between regulatory relief and reduced voluntary disclosure, we acknowledge that our research design cannot completely rule out alternative explanations for this relationship. The observed correlation should not be interpreted as definitive evidence of causation without additional analysis of potential

confounding factors.

CONCLUSION

This study examines how the 2007 Smaller Reporting Company (SRC) Regulatory Relief affected firms' voluntary disclosure decisions through the proprietary costs channel. We investigate whether reduced mandatory disclosure requirements led smaller reporting companies to alter their voluntary disclosure practices in response to competitive threats and proprietary cost concerns. Our analysis contributes to the ongoing debate about the trade-offs between regulatory compliance costs and information transparency in capital markets.

While our empirical analysis faces certain data limitations, our theoretical framework and institutional analysis suggest that the SRC regulatory relief created an interesting tension in firms' disclosure incentives. On one hand, reduced mandatory disclosure requirements lower direct compliance costs, potentially freeing resources for voluntary disclosure. On the other hand, the proprietary cost channel suggests that firms might strategically withhold information to protect competitive advantages, particularly in industries with high proprietary costs. This tension appears especially relevant for smaller firms operating in competitive markets with significant growth opportunities.

The regulatory relief's impact likely varies systematically with industry characteristics and firm-specific factors that influence proprietary costs. Firms in R&D-intensive; industries or those with significant growth opportunities may be particularly sensitive to proprietary cost concerns, consistent with prior literature documenting the relationship between competition and disclosure choices (e.g., Li, 2010; Lang and Sul, 2014). These findings complement existing research on the relationship between mandatory and voluntary disclosure (Beyer et al., 2010).

Our analysis has important implications for regulators and policymakers. The results suggest that while reducing regulatory burdens may benefit smaller firms through cost savings, it could lead to unintended consequences in information environments if firms respond by limiting voluntary disclosure due to proprietary cost concerns. This highlights the need for regulators to carefully consider how disclosure requirements interact with firms' competitive environments when designing scaled disclosure regimes.

For managers and investors, our findings emphasize the strategic nature of voluntary disclosure decisions in competitive markets. Managers must balance the benefits of transparency with proprietary cost concerns, while investors need to consider how regulatory changes might affect information availability across different types of firms. These insights extend the literature on proprietary costs and voluntary disclosure (Verrecchia, 1983; Dye, 1986) to the specific context of scaled disclosure requirements.

Several limitations of our study warrant mention and suggest promising directions for future research. First, the lack of detailed empirical data on firms' proprietary costs limits our ability to make strong causal claims. Future researchers could address this by developing more refined measures of proprietary costs and examining their interaction with regulatory changes. Second, our analysis focuses primarily on the immediate effects of the 2007 regulatory change, leaving room for studies of longer-term impacts and potential strategic responses by competitors. Finally, the interplay between mandatory and voluntary disclosure in different competitive environments deserves further attention, particularly as regulators continue to evaluate scaled disclosure requirements.

Future research could explore how technological changes and evolving business models affect the relationship between proprietary costs and disclosure choices. Additionally, researchers might investigate how the development of alternative information channels influences the proprietary cost considerations in firms' disclosure decisions. Such research

would contribute to our understanding of how regulatory requirements interact with market forces to shape corporate disclosure practices.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	18,045	0.6445	0.9100	0.0000	0.0000	1.6094
Treatment Effect	18,045	0.5823	0.4932	0.0000	1.0000	1.0000
Institutional ownership	18,045	0.5465	0.3208	0.2574	0.5809	0.8228
Firm size	18,045	5.9763	2.0179	4.5194	5.9058	7.3195
Book-to-market	18,045	0.5791	0.5635	0.2750	0.4769	0.7395
ROA	18,045	-0.0382	0.2507	-0.0220	0.0248	0.0702
Stock return	18,045	-0.0145	0.4614	-0.2780	-0.0879	0.1438
Earnings volatility	18,045	0.1509	0.2914	0.0227	0.0552	0.1498
Loss	18,045	0.3024	0.4593	0.0000	0.0000	1.0000
Class action litigation risk	18,045	0.2560	0.2575	0.0701	0.1561	0.3481

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

Table 2
Pearson Correlations
SmallerReportingCompanyRegulatoryRelief Proprietary Costs

	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**	**0.12**	-0.01	**0.16**	**-0.05**	**-0.03**	0.01	**0.06**	**-0.15**
FreqMF	**-0.04**	1.00	**0.44**	**0.44**	**-0.13**	**0.23**	**-0.02**	**-0.14**	**-0.26**	0.00
Institutional ownership	**0.12**	**0.44**	1.00	**0.63**	**-0.07**	**0.26**	**-0.13**	**-0.20**	**-0.20**	0.01
Firm size	-0.01	**0.44**	**0.63**	1.00	**-0.30**	**0.35**	**0.02**	**-0.25**	**-0.38**	**0.07**
Book-to-market	**0.16**	**-0.13**	**-0.07**	**-0.30**	1.00	**0.03**	**-0.21**	**-0.12**	**0.12**	**-0.14**
ROA	**-0.05**	**0.23**	**0.26**	**0.35**	**0.03**	1.00	**0.19**	**-0.52**	**-0.62**	**-0.15**
Stock return	**-0.03**	**-0.02**	**-0.13**	**0.02**	**-0.21**	**0.19**	1.00	**-0.04**	**-0.20**	**-0.06**
Earnings volatility	0.01	**-0.14**	**-0.20**	**-0.25**	**-0.12**	**-0.52**	**-0.04**	1.00	**0.36**	**0.23**
Loss	**0.06**	**-0.26**	**-0.20**	**-0.38**	**0.12**	**-0.62**	**-0.20**	**0.36**	1.00	**0.18**
Class action litigation risk	**-0.15**	0.00	0.01	**0.07**	**-0.14**	**-0.15**	**-0.06**	**0.23**	**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 Smaller Reporting Company Regulatory Relief on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0797*** (5.79)	-0.1176*** (9.48)
Institutional ownership		0.7943*** (31.60)
Firm size		0.0952*** (20.38)
Book-to-market		-0.0401*** (4.37)
ROA		0.1234*** (5.39)
Stock return		-0.0452*** (3.78)
Earnings volatility		0.0810*** (4.08)
Loss		-0.2153*** (14.10)
Class action litigation risk		-0.0274 (1.23)
N	18,045	18,045
R^2	0.0019	0.2544

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