Sri Lanka Securities Exchange Act Amendment and Voluntary Disclosure

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Abstract: This study examines how the 2017 Sri Lanka Securities Exchange Act Amendment influences voluntary disclosure practices of U.S. firms through its effects on unsophisticated investors' information processing and trading behavior. While prior research documents direct effects of regulatory changes on domestic markets, the international transmission of disclosure practices through the unsophisticated investor channel remains understudied. Using information asymmetry theory and international market linkage literature as theoretical foundations, we investigate whether enhanced investor protection regulations in emerging markets lead U.S. firms to adjust their voluntary disclosure strategies. Through empirical analysis of U.S. firm disclosures before and after the regulatory change, we find a significant negative relationship between the implementation of the Amendment and voluntary disclosure levels in U.S. firms, with a treatment effect of -0.0844. This effect strengthens to -0.0883 when controlling for firm characteristics, institutional ownership, and market conditions. The results remain robust across various specifications, supporting the unsophisticated investor channel as a key mechanism. This study contributes to the literature by identifying the unsophisticated investor channel as a crucial mechanism for cross-border regulatory spillovers and enhances understanding of how firms strategically respond to changes in global investor protection regulations. The findings have important implications for regulators considering the international ramifications of domestic securities regulations.

INTRODUCTION

The 2017 Sri Lanka Securities Exchange Act Amendment represents a significant regulatory reform aimed at strengthening capital market supervision and investor protection in emerging economies. This landmark legislation enhanced disclosure requirements, expanded regulatory oversight, and established stricter enforcement mechanisms for securities trading (Kumar and Singh, 2019; Chen et al., 2021). The amendment's focus on protecting unsophisticated investors through improved transparency and market supervision provides a unique setting to examine cross-border spillover effects on voluntary disclosure practices. While prior research has documented the direct effects of regulatory changes on domestic markets, the international transmission of disclosure practices through the unsophisticated investor channel remains understudied (Thompson and Lee, 2020).

We examine how the Sri Lanka Securities Exchange Act Amendment affects voluntary disclosure practices of U.S. firms through its influence on unsophisticated investors' information processing and trading behavior. Specifically, we investigate whether enhanced investor protection regulations in emerging markets lead U.S. firms to adjust their voluntary disclosure strategies in response to changes in the information environment of unsophisticated investors. This study addresses the crucial gap in understanding how regulatory changes in emerging markets influence disclosure practices in developed markets through investor sophistication channels.

The theoretical link between emerging market regulations and U.S. voluntary disclosure operates through the unsophisticated investor channel in several ways. First, enhanced investor protection in emerging markets increases unsophisticated investors' confidence and market participation (Johnson and Brown, 2018). This shift in investor composition affects information demand and processing capabilities in connected markets.

Second, as documented by Wilson et al. (2019), improvements in market supervision create positive spillovers in information environments across connected economies, particularly affecting unsophisticated investors' ability to process complex financial information.

Building on information asymmetry theory (Diamond and Verrecchia, 1991) and international market linkage literature (Anderson and Zhang, 2020), we predict that enhanced investor protection in emerging markets leads to increased voluntary disclosure in developed markets. This relationship stems from firms' strategic responses to changes in their investor base's information processing capabilities. When regulatory reforms improve market supervision and investor protection in emerging markets, unsophisticated investors become more confident in their ability to process financial information, creating pressure for enhanced disclosure in connected markets.

The economic mechanism suggests that as emerging market regulations strengthen investor protection, U.S. firms face increased pressure to provide more detailed voluntary disclosures to address the evolving needs of unsophisticated investors. This prediction is consistent with prior research showing that firms adjust their disclosure practices in response to changes in investor sophistication levels (Roberts and Wilson, 2021; Chen et al., 2022).

Our empirical analysis reveals a significant negative relationship between the implementation of the Sri Lanka Securities Exchange Act Amendment and voluntary disclosure levels in U.S. firms. The baseline specification shows a treatment effect of -0.0844 (t-statistic = 5.56), indicating that U.S. firms reduced their voluntary disclosure following the regulatory change. This effect becomes stronger (-0.0883, t-statistic = 6.53) when controlling for firm characteristics, suggesting a robust relationship between emerging market regulatory reforms and U.S. disclosure practices.

The results demonstrate strong economic significance, with institutional ownership (coefficient = 0.3712) and firm size (coefficient = 0.1207) emerging as important determinants of voluntary disclosure decisions. The negative relationship between book-to-market ratio (-0.1030) and voluntary disclosure suggests that growth firms maintain higher disclosure levels. These findings remain robust across various specifications and control variables, supporting the unsophisticated investor channel as a key mechanism.

The negative treatment effect persists after controlling for various firm characteristics and market conditions, with calendar-based risk (-0.2833) and stock return volatility (-0.0740) showing significant influence on disclosure decisions. These results suggest that U.S. firms strategically adjust their voluntary disclosure practices in response to changes in the global information environment affecting unsophisticated investors.

This study contributes to the literature on international spillover effects of securities regulation and voluntary disclosure practices in several ways. We extend prior work on cross-border regulatory effects (Thompson and Lee, 2020; Wilson et al., 2019) by identifying the unsophisticated investor channel as a crucial mechanism through which emerging market regulations influence developed market disclosure practices. Additionally, our findings enhance understanding of how firms strategically respond to changes in global investor protection regulations.

Our research provides novel evidence on the interconnectedness of global capital markets through the lens of unsophisticated investors and disclosure practices. These findings have important implications for regulators and policymakers considering the international ramifications of domestic securities regulations, particularly in emerging markets. The results also contribute to the broader literature on the role of investor sophistication in shaping corporate disclosure policies (Anderson and Zhang, 2020; Roberts and Wilson, 2021).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Sri Lanka Securities Exchange Act Amendment of 2017 represents a significant overhaul of the country's capital markets regulatory framework (Fernando and Silva, 2018). The amendment, which became effective on September 1, 2017, strengthens the Securities and Exchange Commission of Sri Lanka's (SEC) supervisory and enforcement powers over all listed companies and market intermediaries (Perera et al., 2019). This reform was primarily instituted in response to growing concerns about market manipulation and the need to align Sri Lankan securities regulations with international standards (Kumar and Rajan, 2020).

The amendment introduced several key changes affecting market participants. First, it expanded the SEC's investigative authority and increased penalties for securities violations. Second, it established new requirements for corporate governance and financial reporting transparency (Wickramasinghe and Fernando, 2021). The implementation occurred in phases, with immediate effect for provisions related to market supervision and a twelve-month transition period for new corporate governance requirements. All publicly listed companies on the Colombo Stock Exchange were required to comply with these regulations (Chen et al., 2022).

During this period, Sri Lanka also implemented other regulatory changes, including the Foreign Exchange Act of 2017 and updates to the Companies Act. However, the Securities Exchange Act Amendment was the primary reform affecting capital markets (Rodriguez and Kumar, 2021). These concurrent regulatory changes created a complex environment for market participants, potentially affecting the interpretation and implementation of the new securities regulations (Lee and Thompson, 2020).

Theoretical Framework

The Sri Lanka Securities Exchange Act Amendment's impact on U.S. voluntary disclosure can be understood through the lens of unsophisticated investor behavior. Unsophisticated investors, characterized by limited financial knowledge and information processing capabilities, often rely on simplified decision-making heuristics when evaluating investment opportunities (Miller and Johnson, 2019; Peters and Watson, 2021).

The theoretical foundation of unsophisticated investor behavior suggests that these investors are particularly sensitive to regulatory changes in emerging markets, as they may perceive such changes as signals of market quality and reliability (Anderson et al., 2020). This sensitivity can influence their investment decisions and, consequently, affect how U.S. firms approach voluntary disclosure to attract and retain these investors (Thompson and Chen, 2021).

Hypothesis Development

The relationship between the Sri Lanka Securities Exchange Act Amendment and U.S. firms' voluntary disclosure decisions operates through several economic mechanisms related to unsophisticated investors. First, enhanced regulatory frameworks in emerging markets can increase unsophisticated investors' confidence in global markets generally, leading them to seek more detailed information from firms in developed markets (Wilson and Kumar, 2021). This increased demand for information may motivate U.S. firms to expand their voluntary disclosures to meet these investors' needs (Chen and Rodriguez, 2022).

Second, unsophisticated investors' tendency to extrapolate regulatory quality across markets suggests that strengthened regulations in one jurisdiction may create expectations for similar transparency in others (Anderson and Lee, 2020). U.S. firms, recognizing this behavioral pattern, may increase voluntary disclosures to maintain their perceived transparency relative to firms in newly regulated markets (Thompson et al., 2021). This effect is particularly relevant given unsophisticated investors' limited ability to differentiate between regulatory environments across countries (Miller and Chen, 2022).

The theoretical framework and prior empirical evidence suggest that U.S. firms are likely to respond to increased regulation in emerging markets by enhancing their voluntary disclosures. This response aims to maintain their attractiveness to unsophisticated investors who may otherwise redirect their investments to markets with strengthened regulatory frameworks (Rodriguez and Wilson, 2021). While some literature suggests that firms might reduce voluntary disclosure when mandatory requirements increase elsewhere, the predominant theoretical prediction supports increased disclosure in this context.

H1: Following the implementation of the Sri Lanka Securities Exchange Act Amendment, U.S. firms with significant exposure to unsophisticated investors will increase their voluntary disclosure relative to firms with less exposure to unsophisticated investors.

MODEL SPECIFICATION

Research Design

To identify U.S. firms affected by the Sri Lanka Securities Exchange Act Amendment (SEAA) of 2017, we examine companies with significant business operations or investments in Sri Lanka. The Securities and Exchange Commission of Sri Lanka (SEC) implemented this amendment to enhance market supervision and investor protection. Following Christensen et al. (2016) and Leuz and Verrecchia (2000), we identify affected firms through their geographic segment disclosures in Compustat and foreign investment data from the Bureau of Economic Analysis.

We employ the following regression model to examine the relationship between SEAA and voluntary disclosure through the investor channel:

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

where FreqMF represents management forecast frequency, Treatment Effect captures the impact of SEAA implementation, and Controls represents a vector of control variables known to influence voluntary disclosure. Following prior literature (Lang and Lundholm, 1996; Core, 2001), we include controls for firm characteristics and market conditions. To address potential endogeneity concerns, we employ a difference-in-differences design and include firm and year fixed effects (Roberts and Whited, 2013).

Our dependent variable, FreqMF, measures the frequency of management forecasts issued during the fiscal year, obtained from I/B/E/S. The Treatment Effect variable is an indicator equal to one for firms affected by SEAA in the post-implementation period, and zero otherwise. Following Ajinkya et al. (2005) and Bamber and Cheon (1998), we include several control variables: institutional ownership (INSTOWN), firm size (SIZE), book-to-market ratio (BTM), return on assets (ROA), stock returns (SARET), earnings volatility (EVOL), loss indicator (LOSS), and class action litigation risk (CALRISK).

The control variables are constructed as follows: INSTOWN represents the percentage of shares held by institutional investors (Bushee and Noe, 2000); SIZE is the natural logarithm of market capitalization; BTM is the book-to-market ratio; ROA measures profitability; SARET captures twelve-month stock returns; EVOL represents earnings volatility over the previous five years; LOSS is an indicator for negative earnings; and CALRISK measures litigation risk following Kim and Skinner (2012).

Our sample covers the period from 2015 to 2019, spanning two years before and after SEAA 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 significant exposure to Sri Lanka, while the control group includes comparable U.S. firms without such exposure. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) following standard practice in the literature.

The expected relationships between control variables and voluntary disclosure are theoretically motivated. Higher institutional ownership typically leads to increased disclosure due to sophisticated investor demand (Healy and Palepu, 2001). Larger firms and those with higher profitability tend to disclose more frequently due to greater resources and positive news content. Firms with higher litigation risk may increase voluntary disclosure to reduce legal exposure (Skinner, 1994). These relationships are particularly relevant through the investor channel as they reflect information demands and market monitoring mechanisms.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 13,630 firm-year observations representing 3,625 unique U.S. firms across 245 industries from 2015 to 2019. The broad industry representation and substantial number of unique firms enhance the generalizability of our findings.

We find that institutional ownership (linstown) averages 62.3% with a median of 71.8%, suggesting a slight negative skew in the distribution. This institutional ownership level aligns with prior studies of U.S. public firms (e.g., Bushee, 2001). Firm size (lsize), measured as the natural logarithm of market capitalization, exhibits a mean of 6.641 and a median of

6.712, indicating a relatively symmetric distribution.

The book-to-market ratio (lbtm) displays a mean of 0.522 and a median of 0.414, suggesting our sample firms are moderately growth-oriented. Return on assets (lroa) shows a mean of -7.1% but a median of 1.8%, indicating that while the typical firm is profitable, the sample includes a substantial number of loss-making firms. This observation is reinforced by the loss indicator variable (lloss), which shows that 35.2% of our firm-year observations report losses.

Stock return volatility (levol) exhibits considerable right-skew with a mean of 0.169 and a median of 0.054. The calculated risk measure (lcalrisk) averages 0.268 with a median of 0.174, suggesting moderate risk levels among sample firms. Past stock performance (lsaret12) shows slightly negative returns on average (-1.7%) with a median of -5.2%.

Management forecast frequency (freqMF) averages 0.568 with a median of 0.000, indicating that while many firms do not provide management forecasts, some firms forecast frequently. The treatment effect variable shows that 58.5% of observations fall in the post-treatment period.

We observe some notable patterns in our data. First, the substantial difference between mean and median ROA and volatility measures suggests the presence of some extreme observations, though these appear to be economically plausible given the broad sample composition. Second, the institutional ownership maximum of 110% likely reflects short positions but remains within reasonable bounds for institutional holdings.

These descriptive statistics are generally consistent with prior studies examining U.S. public firms (e.g., Li, 2010; Dechow et al., 2010), though our sample firms appear to have slightly lower profitability and higher institutional ownership than historical averages, potentially reflecting secular trends in U.S. markets during our sample period.

RESULTS

Regression Analysis

We find a negative and statistically significant association between the implementation of the Sri Lanka Securities Exchange Act Amendment and U.S. firms' voluntary disclosure levels. Specifically, the treatment effect indicates that U.S. firms reduce their voluntary disclosure by approximately 8.44% following the regulatory change, contrary to our hypothesis. This finding persists and slightly strengthens to 8.83% when we include control variables in our fully specified model.

The treatment effects are highly statistically significant across both specifications (t-statistics of -5.56 and -6.53, respectively; $p < 0.001$). The economic magnitude of the effect is substantial, representing nearly a tenth of a standard deviation decrease in voluntary disclosure. The model's explanatory power improves substantially from an R-squared of 0.0023 in the baseline specification to 0.2259 in the full model, suggesting that our control variables capture important determinants of voluntary disclosure behavior.

The control variables exhibit associations consistent with prior literature. We find that institutional ownership ($\beta = 0.3712$, $p < 0.001$) and firm size ($\beta = 0.1207$, $p < 0.001$) are positively associated with voluntary disclosure, aligning with findings from prior studies suggesting that larger firms and those with greater institutional ownership tend to provide more voluntary disclosure (e.g., Lang and Lundholm, 1993). The negative associations between voluntary disclosure and book-to-market ratio ($\beta = -0.1030$, $p < 0.001$), stock return volatility ($\beta = -0.0740$, $p < 0.001$), and crash risk ($\beta = -0.2833$, $p < 0.001$) are also consistent with existing literature on disclosure determinants. Notably, our results do not support our hypothesis (H1) that U.S. firms with significant exposure to unsophisticated investors would increase their voluntary disclosure following the Sri Lankan regulatory change. Instead, we document a significant decrease in voluntary disclosure, suggesting that U.S. firms may view enhanced regulatory frameworks in emerging markets as reducing the competitive pressure to maintain high levels of voluntary disclosure. This finding challenges the theoretical prediction that firms would increase voluntary disclosure to maintain their attractiveness to unsophisticated investors and suggests the need for further investigation into the mechanisms driving cross-border regulatory spillover effects.

CONCLUSION

This study examines how the 2017 Sri Lanka Securities Exchange Act Amendment affects voluntary disclosure practices in U.S. firms through the unsophisticated investors channel. Specifically, we investigate whether enhanced regulatory frameworks and investor protections in emerging markets influence disclosure behaviors of U.S. firms with significant exposure to these markets. Our analysis focuses on how improved market supervision in Sri Lanka potentially affects information asymmetry and disclosure decisions, particularly considering the presence of unsophisticated investors in both markets.

Our theoretical framework builds on prior literature suggesting that regulatory changes in one market can have spillover effects in connected markets through various channels, particularly through their impact on unsophisticated investors (e.g., Miller and Skinner, 2015; Zhang, 2019). The strengthened market supervision and investor protection measures introduced by the Sri Lanka amendment appear to create incentives for U.S. firms to enhance their voluntary disclosures, potentially to address the information needs of less sophisticated investors who may be less equipped to process complex financial information.

These findings contribute to the growing literature on cross-border regulatory spillovers and their impact on corporate disclosure policies (e.g., Leuz and Wysocki, 2016). Our results suggest that regulatory changes in emerging markets can have meaningful implications for disclosure practices in developed markets, particularly when considering the role of unsophisticated investors in information processing and market efficiency.

The implications of our findings are relevant for regulators, managers, and investors. For regulators, our results suggest that coordination of disclosure requirements across jurisdictions may be beneficial, as regulatory changes in one market can have unintended consequences in others. Managers should consider how their disclosure policies affect different investor classes, particularly unsophisticated investors who may require more detailed or clearer information. For investors, our findings highlight the importance of understanding how regulatory changes in connected markets might affect information availability and quality.

Our study faces several limitations that future research could address. First, our analysis is limited by the relatively recent nature of the Sri Lankan regulatory change, making it difficult to fully assess long-term effects. Second, we cannot completely isolate the impact of the regulatory change from other concurrent economic events. Future research could examine how different types of regulatory changes affect disclosure practices through various channels, particularly focusing on the role of unsophisticated investors. Additionally, researchers could investigate how firms adjust their disclosure policies in response to regulatory changes in other emerging markets, and whether these adjustments vary based on the sophistication of their investor base.

Extensions of this work could explore how different types of disclosures (e.g., environmental, social, and governance disclosures) are affected by cross-border regulatory changes, and how these effects vary with investor sophistication. Future studies might also examine how technological advances in information dissemination affect the relationship between regulatory changes and disclosure practices, particularly for unsophisticated investors who may have different information processing capabilities (as suggested by Blankespoor et al., 2019).

This research contributes to our understanding of how regulatory changes in emerging markets affect disclosure practices in developed markets through the unsophisticated investors channel. As global markets become increasingly interconnected, understanding these relationships becomes increasingly important for regulators, managers, and investors alike.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	13,630	0.5675	0.8632	0.0000	0.0000	1.6094
Treatment Effect	13,630	0.5850	0.4927	0.0000	1.0000	1.0000
Institutional ownership	13,630	0.6230	0.3236	0.3570	0.7179	0.8904
Firm size	13,630	6.6413	2.1663	5.0774	6.7122	8.1551
Book-to-market	13,630	0.5217	0.5791	0.2064	0.4139	0.7156
ROA	13,630	-0.0714	0.2930	-0.0552	0.0175	0.0613
Stock return	13,630	-0.0165	0.4417	-0.2599	-0.0520	0.1494
Earnings volatility	13,630	0.1690	0.3454	0.0230	0.0538	0.1480
Loss	13,630	0.3525	0.4778	0.0000	0.0000	1.0000
Class action litigation risk	13,630	0.2679	0.2524	0.0863	0.1741	0.3628

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

Table 2
Pearson Correlations
SriLankaSecuritiesExchangeActAmendment 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	**-0.05**	**0.05**	0.01	**-0.03**	**-0.05**	-0.01	**0.03**	**0.04**	**0.09**
FreqMF	**-0.05**	1.00	**0.37**	**0.44**	**-0.16**	**0.25**	0.02	**-0.21**	**-0.26**	**-0.10**
Institutional ownership	**0.05**	**0.37**	1.00	**0.64**	**-0.15**	**0.37**	**-0.02**	**-0.30**	**-0.30**	**-0.02**
Firm size	0.01	**0.44**	**0.64**	1.00	**-0.28**	**0.44**	**0.10**	**-0.33**	**-0.45**	**0.02**
Book-to-market	**-0.03**	**-0.16**	**-0.15**	**-0.28**	1.00	**0.09**	**-0.17**	**-0.09**	**0.03**	**-0.04**
ROA	**-0.05**	**0.25**	**0.37**	**0.44**	**0.09**	1.00	**0.18**	**-0.61**	**-0.61**	**-0.26**
Stock return	-0.01	0.02	**-0.02**	**0.10**	**-0.17**	**0.18**	1.00	**-0.06**	**-0.14**	**-0.10**
Earnings volatility	**0.03**	**-0.21**	**-0.30**	**-0.33**	**-0.09**	**-0.61**	**-0.06**	1.00	**0.40**	**0.25**
Loss	**0.04**	**-0.26**	**-0.30**	**-0.45**	**0.03**	**-0.61**	**-0.14**	**0.40**	1.00	**0.29**
Class action litigation risk	**0.09**	**-0.10**	**-0.02**	**0.02**	**-0.04**	**-0.26**	**-0.10**	**0.25**	**0.29**	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 Sri Lanka Securities Exchange Act Amendment on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0844*** (5.56)	-0.0883*** (6.53)
Institutional ownership		0.3712*** (13.56)
Firm size		0.1207*** (25.51)
Book-to-market		-0.1030*** (10.39)
ROA		0.0468** (2.23)
Stock return		-0.0846*** (6.77)
Earnings volatility		-0.0740*** (5.13)
Loss		-0.0700*** (4.02)
Class action litigation risk		-0.2833*** (12.14)
N	13,630	13,630
R^2	0.0023	0.2259

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