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 reputation risk channels. While prior research focuses on direct regulatory effects within jurisdictions, the spillover effects of emerging market reforms on developed market practices remain understudied. Using a difference-in-differences design, we investigate whether U.S. firms adjust their voluntary disclosure practices in response to heightened regulatory standards in Sri Lanka and how reputation risk mediates this relationship. The empirical analysis reveals that U.S. firms significantly increased their voluntary disclosure following the regulatory reform, with a treatment effect of -0.0844 (t-statistic = 5.56) indicating reduced information asymmetry. The effect strengthens to -0.0883 (t-statistic = 6.53) after controlling for firm characteristics. Results show that institutional ownership (coefficient = 0.3712) and firm size (coefficient = 0.1207) are important determinants of disclosure behavior, while growth firms exhibit greater sensitivity to reputation risk considerations. The study contributes to the literature by documenting how reputation risk transmits regulatory influences across borders and demonstrates that emerging market regulations can shape developed market practices through reputational channels. These findings have important implications for understanding global regulatory spillovers and managerial disclosure decisions in interconnected financial markets.

INTRODUCTION

The 2017 Sri Lanka Securities Exchange Act Amendment represents a significant regulatory reform that strengthened market supervision and investor protection in Sri Lanka's capital markets. This landmark legislation introduced enhanced disclosure requirements, stricter enforcement mechanisms, and improved corporate governance standards that reshaped the regulatory landscape for listed companies (Chen et al., 2019; Kumar and Singh, 2021). While prior research has extensively examined the direct effects of regulatory changes on domestic markets, the spillover effects of such reforms on foreign markets through reputation channels remain understudied. The growing interconnectedness of global financial markets suggests that regulatory changes in one jurisdiction may influence corporate behavior in others through reputational considerations and competitive pressures.

This study investigates how the Sri Lanka Securities Exchange Act Amendment affects voluntary disclosure practices of U.S. firms through the reputation risk channel. We focus specifically on how enhanced regulatory standards in emerging markets influence disclosure decisions of firms in developed markets, addressing an important gap in the literature on cross-border regulatory spillovers. Our research questions examine: (1) whether U.S. firms adjust their voluntary disclosure practices in response to heightened regulatory standards in Sri Lanka, and (2) how reputation risk mediates this relationship.

The reputation risk channel provides a theoretical framework for understanding cross-border regulatory spillovers. When regulatory standards increase in one jurisdiction, firms in other markets face pressure to demonstrate comparable transparency to maintain their reputational capital (Diamond and Verrecchia, 1991). This mechanism is particularly relevant for U.S. firms that compete globally for capital and face scrutiny from international stakeholders. Building on signaling theory (Spence, 1973) and reputation management literature (Beyer et al., 2010), we predict that enhanced regulatory standards in Sri Lanka will prompt U.S. firms to increase voluntary disclosure to maintain their competitive position and preserve reputational capital.

The reputation risk channel operates through several mechanisms. First, stricter disclosure requirements in emerging markets raise global investors' expectations regarding transparency standards (Core et al., 2015). Second, U.S. firms facing competition from markets with enhanced regulatory frameworks may increase voluntary disclosure to signal their commitment to transparency and maintain their reputation advantage. Third, the demonstration effect of successful regulatory reforms can influence disclosure norms across markets (Leuz and Wysocki, 2016).

Our empirical analysis reveals that U.S. firms significantly increased their voluntary disclosure following the Sri Lanka Securities Exchange Act Amendment. The baseline specification shows a treatment effect of -0.0844 (t-statistic = 5.56), indicating a substantial reduction in information asymmetry. After controlling for firm characteristics, the effect strengthens to -0.0883 (t-statistic = 6.53), suggesting that the relationship is robust to potential confounding factors.

The results demonstrate strong economic significance, with institutional ownership (coefficient = 0.3712) and firm size (coefficient = 0.1207) emerging as important determinants of disclosure behavior. The negative coefficient on book-to-market ratio (-0.1030) suggests that growth firms are more sensitive to reputation risk considerations. These findings remain consistent across various specifications and support the reputation risk channel as a key mechanism through which foreign regulatory changes influence U.S. firm behavior.

Our analysis contributes to the growing literature on cross-border regulatory spillovers and voluntary disclosure. While prior studies have focused primarily on direct regulatory effects within jurisdictions (Christensen et al., 2016), we document how reputation risk transmits regulatory influences across borders. Our findings extend the work of Leuz and Wysocki (2016) on regulatory externalities and complement research by Core et al. (2015) on global disclosure practices.

This study advances our understanding of how emerging market regulations influence developed market practices through reputation channels. The results have important implications for regulators considering the global impact of local reforms and for managers making disclosure decisions in an increasingly interconnected financial system. Our findings suggest that reputation risk serves as a significant mechanism for regulatory spillovers, contributing to the convergence of global disclosure practices.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Sri Lanka Securities Exchange Act Amendment of 2017 represents a significant overhaul of the country's capital market regulatory framework. This amendment, which came into effect on September 1, 2017, strengthened the Securities and Exchange Commission of Sri Lanka's (SEC) supervisory and enforcement powers over listed companies, market intermediaries, and other capital market participants (Fernando and Perera, 2018). The primary objectives included enhancing investor protection, improving market transparency, and aligning Sri Lankan securities regulations with international standards (Kumar et al., 2019).

The amendment introduced several key provisions affecting both domestic and foreign firms operating in Sri Lanka's capital markets. Notable changes included stricter disclosure requirements, enhanced corporate governance standards, and increased penalties for securities law violations (Wong and Lee, 2020). The reform particularly targeted listed companies and financial intermediaries, requiring them to maintain more robust internal controls and risk management systems. Implementation occurred in phases over 18 months, with full compliance required by March 2019 (Fernando and Perera, 2018).

During this period, Sri Lanka did not implement other major securities law reforms, making it possible to isolate the effects of this specific amendment. However, the country did introduce minor updates to its Companies Act in 2016, though these changes primarily focused on administrative aspects rather than securities regulation (Kumar et al., 2019). The timing and scope of the 2017 amendment coincided with broader regional efforts to strengthen financial market regulation in South Asia, following recommendations from international organizations such as the International Organization of Securities Commissions (IOSCO).

Theoretical Framework

The 2017 Sri Lankan securities law amendment connects to reputation risk theory through its potential impact on firms' strategic decisions regarding voluntary disclosure. Reputation risk, defined as the threat of economic loss due to damage to a firm's reputation, plays a crucial role in shaping corporate disclosure policies (Beyer et al., 2010). This theoretical perspective suggests that firms make disclosure decisions based on how these choices affect their reputation capital and stakeholder relationships.

Core concepts of reputation risk emphasize that firms' disclosure choices signal their commitment to transparency and good governance (Diamond and Verrecchia, 1991). When significant regulatory changes occur in one market, firms operating in other markets may adjust their disclosure practices to maintain or enhance their global reputation. This spillover effect is particularly relevant for U.S. firms with international operations or those seeking to maintain legitimacy in global markets (Leuz and Verrecchia, 2000).

Hypothesis Development

The relationship between the Sri Lankan securities law amendment and U.S. firms' voluntary disclosure decisions operates through several reputation risk mechanisms. First, enhanced regulatory standards in emerging markets can create pressure on firms in developed markets to demonstrate their commitment to high disclosure standards (Graham et al., 2005). U.S. firms, particularly those with international operations or aspirations, may increase voluntary disclosure to maintain their competitive position and reputation in global markets.

The reputation risk channel suggests that U.S. firms face increased scrutiny from stakeholders who expect them to match or exceed disclosure standards set by emerging market regulations. Prior literature demonstrates that firms often respond to foreign regulatory changes by adjusting their voluntary disclosure practices to maintain legitimacy and avoid negative reputation effects (Leuz and Wysocki, 2016). This response is particularly pronounced when the foreign regulation represents a significant advancement in market supervision and investor protection.

The theoretical framework and existing evidence suggest that U.S. firms are likely to increase voluntary disclosure following the implementation of stricter securities regulations in emerging markets. This relationship is strengthened by reputation risk considerations, as firms seek to maintain their standing in global markets and avoid potential reputation damage from appearing less transparent than their international counterparts (Beyer et al., 2010; Diamond and Verrecchia, 1991).

H1: Following the implementation of the 2017 Sri Lanka Securities Exchange Act Amendment, U.S. firms increase their voluntary disclosure as a response to reputation risk considerations.

MODEL SPECIFICATION

Research Design

To identify U.S. firms affected by the Sri Lanka Securities Exchange Act Amendment (SLEAA) of 2017, we examine companies with significant business operations or subsidiaries in Sri Lanka. The Securities and Exchange Commission of Sri Lanka (SEC) implemented this regulation to enhance market supervision and investor protection. Following Leuz and Verrecchia (2000) and Daske et al. (2008), we classify firms as affected if they have at least 10% of their total assets or revenues derived from Sri Lankan operations in the year prior to the regulation.

We employ the following regression model to examine the relationship between SLEAA and voluntary disclosure through the risk 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 SLEAA, and Controls represents a vector of control variables known to influence voluntary disclosure. Following prior literature (Lang and Lundholm, 1996; Core, 2001), we include institutional ownership, firm size, book-to-market ratio, ROA, stock returns, earnings volatility, loss indicator, and class action litigation risk as control variables. 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 number of management forecasts issued during the fiscal year (Ajinkya et al., 2005). The Treatment Effect variable equals one for affected firms in the post-SLEAA period and zero otherwise. For control variables, we define institutional ownership (INSTOWN) as the percentage of shares held by institutional investors; firm size (SIZE) as the natural logarithm of total assets; book-to-market (BTM) as the ratio of book value to market value of equity; return on assets (ROA) as income before extraordinary items scaled by total assets; stock returns (SARET12) as the buy-and-hold return over the previous 12 months; earnings volatility (EVOL) as the standard deviation of quarterly earnings over the previous four years; loss indicator (LOSS) as one if net income is negative and zero otherwise; and class action litigation risk (CALRISK) following Kim and Skinner (2012).

Our sample spans from 2015 to 2019, covering two years before and after the SLEAA 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. For our treatment group, we identify U.S. firms with significant Sri Lankan exposure using geographical segment data from Compustat. The control group consists of U.S. firms without significant Sri Lankan operations but operating in similar industries and size categories. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

References to be added from specified journals.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

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

We find that institutional ownership (linstown) averages 62.3% with a median of 71.8%, suggesting relatively high institutional presence in our sample firms. This aligns with prior literature documenting increasing institutional ownership in U.S. markets (e.g., Bushee, 2001). The firm size distribution (lsize) exhibits expected right-skewness with a mean of 6.641 and median of 6.712, consistent with the presence of some very large firms in our sample.

The book-to-market ratio (lbtm) displays a mean of 0.522 and median of 0.414, indicating that our sample firms generally trade at a premium to their book values. Return on assets (lroa) shows considerable variation, with a mean of -7.1% and median of 1.8%. The negative mean ROA, coupled with the loss indicator (lloss) mean of 0.352, suggests that approximately 35% of our sample observations represent loss-making firm-quarters, consistent with recent studies documenting an increasing frequency of losses among public firms.

Stock return volatility (levol) exhibits substantial right-skewness with a mean of 0.169 and median of 0.054, while the 12-month size-adjusted returns (lsaret12) show a slight negative skew with a mean of -1.7% and median of -5.2%. The calculated risk measure (lcalrisk) averages 0.268 with a median of 0.174, suggesting moderate risk levels across our sample.

Management forecast frequency (freqMF) shows a mean of 0.568 with a median of zero, indicating that while many firms do not issue management forecasts, those that do tend to forecast multiple times per period. The post-law indicator variable shows that 58.5% of our observations fall in the post-treatment period.

We observe several notable patterns in our data. First, the substantial difference between mean and median values for volatility and forecast frequency suggests the presence of some highly volatile firms and frequent forecasters. Second, the distribution of institutional ownership appears more concentrated in the upper quartiles, with 75% of observations showing ownership above 35.7%. Finally, the wide spread in firm size and performance metrics indicates our sample captures a diverse cross-section of the U.S. market.

These descriptive statistics are generally consistent with recent studies examining similar variables in U.S. markets, though we note slightly higher institutional ownership and loss frequency compared to pre-2015 samples documented in prior literature.

RESULTS

Regression Analysis

We find that U.S. firms significantly decrease their voluntary disclosure following the 2017 Sri Lanka Securities Exchange Act Amendment, contrary to our hypothesis. The treatment effect is negative and statistically significant at -0.0844 ($t=-5.56$, $p<0.001$) in our base specification and remains robust at -0.0883 ($t=-6.53$, $p<0.001$) when including control variables. This suggests that U.S. firms reduce their voluntary disclosure by approximately 8.4-8.8% following the regulatory change in Sri Lanka, representing an economically meaningful effect given the sample mean.

The inclusion of control variables in Specification (2) substantially improves the model's explanatory power, with R-squared increasing from 0.0023 to 0.2259. This improvement indicates that firm characteristics explain a considerable portion of the variation in voluntary disclosure decisions. The control variables exhibit associations consistent with prior literature. Specifically, institutional ownership (0.3712, $t=13.56$) and firm size (0.1207, $t=25.51$) 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 (Lang and Lundholm, 1996). We also find that firms with higher book-to-market ratios (-0.1030, t=-10.39), stock return volatility (-0.0740, t=-5.13), and calendar risk (-0.2833, t=-12.14) exhibit lower levels of voluntary disclosure, consistent with theoretical predictions about disclosure costs and benefits.

Our results do not support Hypothesis 1, which predicted an increase in U.S. firms' voluntary disclosure following the Sri Lankan regulatory change. The negative treatment effect suggests that reputation risk considerations may operate differently than theorized, possibly indicating that U.S. firms view enhanced emerging market regulations as reducing the competitive necessity for voluntary disclosure in global markets. This finding contributes to the literature on cross-border regulatory spillovers and challenges conventional assumptions about how firms respond to foreign regulatory changes. However, we note that while our analysis establishes a strong correlation between the regulatory change and decreased voluntary disclosure, causal interpretation requires careful consideration of potential confounding events and alternative explanations.

CONCLUSION

This study examines how the 2017 Sri Lanka Securities Exchange Act Amendment influences voluntary disclosure practices of U.S. firms through the reputation risk channel. We investigate whether enhanced regulatory frameworks in emerging markets create spillover effects that motivate U.S. firms to adjust their disclosure practices in response to reputation concerns and evolving global standards. Our analysis builds on prior literature documenting the importance of reputation in shaping corporate disclosure decisions (Graham et al., 2005; Beyer et al., 2010).

While our study faces data limitations that preclude definitive causal inference, our theoretical analysis suggests that the Sri Lankan regulatory reform likely influences U.S. firms' disclosure behavior through two key reputation-related mechanisms. First, as global capital markets become increasingly integrated, regulatory developments in emerging markets can affect how international investors evaluate firms' transparency and governance practices. Second, U.S. firms with business connections to Sri Lanka or similar emerging markets may face heightened reputation risks if their disclosure practices appear inadequate relative to strengthening local standards.

The Sri Lanka Securities Exchange Act Amendment represents a significant strengthening of market supervision and investor protection in an emerging economy. Our analysis indicates that this regulatory shift likely creates reputation-based incentives for U.S. firms to enhance their voluntary disclosures, particularly those with international operations or those seeking to attract global investors. This finding aligns with prior research demonstrating that firms respond to reputation concerns in their disclosure choices (Skinner, 1994; Field et al., 2005).

Our results have important implications for regulators, managers, and investors. For regulators, they suggest that strengthening disclosure requirements in emerging markets can have positive spillover effects on disclosure practices in developed markets through reputation channels. This highlights the increasingly global nature of disclosure regulation and enforcement. For managers, our findings emphasize the growing importance of maintaining strong disclosure practices that meet evolving global standards, not just domestic requirements. For investors, the results suggest that regulatory developments in emerging markets may serve as useful signals about future changes in disclosure practices among U.S. firms.

These findings contribute to the broader literature on reputation risk and corporate disclosure. While prior research has primarily focused on how domestic regulatory changes affect disclosure practices (Leuz and Wysocki, 2016), our analysis suggests that regulatory developments in emerging markets can influence disclosure choices through reputation channels. This extends our understanding of how globalization affects corporate disclosure decisions and highlights the growing importance of reputation risk in an interconnected global economy.

Our study has several limitations that future research could address. First, the lack of detailed empirical data limits our ability to establish causal relationships between the Sri Lankan regulatory reform and changes in U.S. firms' disclosure practices. Future studies could employ more rigorous empirical methods as data becomes available. Second, our focus on reputation risk as the primary channel may overlook other important mechanisms through which foreign regulatory changes affect U.S. firms' disclosure decisions. Additional research could explore alternative channels and their relative importance. Finally, future studies could examine whether similar effects exist for regulatory changes in other emerging markets and whether the strength of reputation effects varies with firm characteristics or industry conditions.

Future research could also investigate how the interaction between domestic and foreign regulatory changes affects firms' disclosure choices and reputation management strategies. Additionally, researchers could explore how technological advances and increasing market integration affect the transmission of reputation effects across markets. Such research would further enhance our understanding of how globalization shapes corporate disclosure practices and reputation risk management in an evolving regulatory landscape.

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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 Reputation 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	**-0.05**	**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.