Bad Actor Disqualification and Voluntary Disclosure

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Abstract: This study examines how the SEC's 2013 Bad Actor Disqualification rule affects firms' voluntary disclosure practices through changes in litigation risk. The regulation, which disqualifies certain parties from participating in private placements, creates a natural experiment to investigate the relationship between enhanced enforcement mechanisms and corporate disclosure decisions. Using established theoretical frameworks of disclosure choice under litigation risk, we analyze firms' disclosure patterns before and after the rule's implementation. Our empirical analysis reveals a dynamic response pattern: firms initially increased voluntary disclosure (treatment effect = 0.0313, $p < 0.05$), followed by a significant reduction after controlling for firm characteristics (treatment effect = -0.0573, $p < 0.001$). The results demonstrate that institutional ownership and firm size significantly influence this relationship, while calendar risk exhibits a negative association with voluntary disclosure. These findings indicate that firms actively adjust their disclosure strategies in response to enhanced enforcement mechanisms, balancing transparency demands against increased legal exposure. The study contributes to the literature by providing novel evidence on how specific regulatory enforcement mechanisms shape corporate communication strategies, offering insights for regulators on the broader effects of enhanced enforcement provisions on market transparency and information flow.

INTRODUCTION

The Securities and Exchange Commission's Bad Actor Disqualification rule of 2013 represents a significant shift in the regulatory landscape governing private securities offerings. This regulation, which disqualifies certain "bad actors" from participating in private placements, fundamentally altered the litigation risk environment faced by firms engaging in exempt offerings under Regulation D (Coffee and Sale, 2018). The rule's implementation creates a natural experiment to examine how changes in litigation risk affect firms' voluntary disclosure decisions, particularly given the enhanced scrutiny and potential penalties faced by firms with prior securities law violations (Lowry and Shu, 2022).

Understanding how Bad Actor Disqualification affects voluntary disclosure through the litigation risk channel addresses a crucial gap in our knowledge of how regulatory enforcement mechanisms shape corporate communication strategies. While prior research establishes that litigation risk influences voluntary disclosure (Field, Lowry, and Shu, 2005), the specific impact of enhanced disqualification provisions remains unexplored. We examine whether and how firms adjust their voluntary disclosure practices in response to increased litigation risk stemming from Bad Actor Disqualification.

The theoretical link between Bad Actor Disqualification and voluntary disclosure operates primarily through the litigation risk channel. Enhanced disqualification provisions increase the expected costs of securities law violations, thereby affecting firms' risk-return calculations regarding voluntary disclosure (Skinner, 1994). This heightened litigation risk creates incentives for firms to adjust their disclosure practices to minimize legal exposure while maintaining information flow to capital markets (Rogers and Van Buskirk, 2009).

The litigation risk channel suggests two competing effects on voluntary disclosure. On one hand, increased litigation risk may motivate firms to enhance disclosure quality and

frequency to reduce information asymmetry and demonstrate regulatory compliance (Healy and Palepu, 2001). Conversely, firms might reduce voluntary disclosure to minimize potential legal liability arising from forward-looking statements or other discretionary disclosures (Johnson, Kasznik, and Nelson, 2001). The net effect depends on the relative strength of these opposing forces.

Building on established theoretical frameworks of disclosure choice under litigation risk (Verrecchia, 2001), we predict that Bad Actor Disqualification will significantly affect firms' voluntary disclosure practices. Specifically, we hypothesize that firms will initially increase disclosure to signal compliance and transparency, but may subsequently reduce discretionary disclosure as they better understand the heightened litigation risks imposed by the regulation.

Our empirical analysis reveals significant changes in voluntary disclosure following the implementation of Bad Actor Disqualification. The initial specification shows a positive treatment effect of 0.0313 (t-statistic = 2.06, p-value = 0.0392), suggesting an initial increase in voluntary disclosure. However, after controlling for firm characteristics, we find a negative treatment effect of -0.0573 (t-statistic = 4.10, p-value = 0.000), indicating a subsequent reduction in voluntary disclosure.

The results demonstrate strong economic significance, with institutional ownership (coefficient = 0.5015, t-statistic = 18.67) and firm size (coefficient = 0.1232, t-statistic = 25.29) emerging as particularly important control variables. The negative relationship between calendar risk and voluntary disclosure (coefficient = -0.1731, t-statistic = -7.40) further supports the litigation risk channel as the primary mechanism.

These findings suggest that Bad Actor Disqualification fundamentally altered firms' disclosure strategies through the litigation risk channel. The initial increase followed by a decrease in voluntary disclosure indicates that firms actively manage their disclosure policies in response to changes in the regulatory environment, consistent with theoretical predictions about disclosure choices under litigation risk.

This study contributes to the literature on regulatory impacts and voluntary disclosure by providing novel evidence on how enhanced enforcement mechanisms affect corporate communication strategies. While prior research examines general effects of litigation risk on disclosure (Kothari, Shu, and Wysocki, 2009), our findings specifically illuminate how Bad Actor Disqualification affects disclosure through the litigation risk channel. These results have important implications for understanding how firms balance transparency and legal exposure in their disclosure decisions.

Our analysis extends recent work on the effectiveness of securities regulation (Christensen, Hail, and Leuz, 2016) by demonstrating how specific enforcement mechanisms influence corporate behavior. The findings provide valuable insights for regulators considering the broader effects of enhanced enforcement provisions on market transparency and information flow.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Bad Actor Disqualification provisions, implemented by the Securities and Exchange Commission (SEC) in September 2013, represent a significant enhancement to investor protection in private securities offerings (SEC, 2013). This regulation prohibits certain individuals and entities with a history of securities law violations from participating in Rule

506 offerings, which constitute the most widely used exemption under Regulation D (Dimmock and Gerken, 2012; Bernstein et al., 2019). The provisions were mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, responding to concerns about recurring fraudulent activities in private placements (Coffee, 2014).

The implementation of these provisions marked a substantial shift in the regulatory landscape, affecting both issuers and market participants. The disqualification applies to various "covered persons," including issuers, their predecessors, affiliated issuers, directors, officers, general partners, managing members, beneficial owners of 20% or more of the issuer's voting equity securities, promoters, investment managers, and persons compensated for soliciting investors (Pritchard and Nelson, 2016). The provisions are triggered by various disqualifying events, including criminal convictions, court injunctions, SEC disciplinary orders, and other regulatory actions related to securities violations (Grundfest, 2015).

Notably, the Bad Actor Disqualification provisions were implemented during a period of significant regulatory reform in U.S. securities markets. Concurrent changes included the JOBS Act provisions and modifications to general solicitation rules under Rule 506(c) (Dambra et al., 2015). However, the Bad Actor provisions specifically targeted investor protection in private offerings, distinguishing them from other contemporary regulatory changes that focused on capital formation and market access (Chaplinsky et al., 2017).

Theoretical Framework

The Bad Actor Disqualification provisions operate primarily through the litigation risk channel, affecting firms' disclosure decisions and market behavior. Litigation risk theory suggests that firms' disclosure choices are significantly influenced by their assessment of potential legal liability (Skinner, 1994; Field et al., 2005). The provisions create an additional layer of scrutiny and potential consequences for firms and their associated parties, thereby

altering the cost-benefit calculation of disclosure decisions.

Core concepts of litigation risk in accounting literature emphasize that firms balance the benefits of disclosure against potential legal exposure (Rogers and Van Buskirk, 2009). This theoretical framework suggests that increased litigation risk can lead to either more conservative disclosure practices to avoid legal liability or enhanced disclosure to preempt litigation (Francis et al., 1994; Kim and Skinner, 2012).

Hypothesis Development

The implementation of Bad Actor Disqualification provisions likely influences firms' voluntary disclosure decisions through multiple mechanisms within the litigation risk framework. First, the increased scrutiny and potential consequences of being classified as a "bad actor" create strong incentives for firms to maintain transparency and demonstrate compliance (Lowry and Shu, 2002). The provisions effectively raise the stakes for firms engaging in securities offerings, as disqualification would significantly impact their ability to raise capital through private placements (Hanley and Hoberg, 2012).

The relationship between Bad Actor Disqualification and voluntary disclosure is theoretically complex. On one hand, increased litigation risk typically motivates firms to enhance voluntary disclosure to reduce information asymmetry and demonstrate good faith to investors (Rogers and Stocken, 2005). This perspective suggests that firms would increase voluntary disclosure to differentiate themselves from potential "bad actors" and signal their quality to the market (Verrecchia, 2001). On the other hand, the severe consequences of being labeled a "bad actor" might lead firms to adopt more conservative disclosure practices to minimize the risk of making statements that could later be deemed misleading or fraudulent (Johnson et al., 2001).

Prior literature on regulatory enforcement and disclosure suggests that when penalties for misconduct are severe, firms tend to err on the side of greater transparency (Leuz and Wysocki, 2016). The Bad Actor Disqualification provisions create substantial costs for non-compliance, including the inability to participate in private offerings, which represents a significant deterrent. This aligns with theoretical predictions that higher litigation risk leads to more comprehensive voluntary disclosure when the costs of non-disclosure exceed the proprietary costs of disclosure (Dye, 2001; Verrecchia, 2001).

H1: Following the implementation of Bad Actor Disqualification provisions, firms increase their voluntary disclosure as a response to heightened litigation risk.

MODEL SPECIFICATION

Research Design

We identify firms affected by the SEC's Bad Actor Disqualification rule implemented in 2013 through a comprehensive screening process. First, we collect enforcement actions from the SEC's Administrative Proceedings and Litigation Releases databases. We then match these actions to firms in our sample using company names and CIK numbers. Following Karpoff et al. (2008), we classify firms as bad actors if they or their executives were subject to SEC enforcement actions involving securities fraud, material misstatements, or other disqualifying events specified in Rule 506(d).

Our primary empirical specification examines the impact of Bad Actor Disqualification on voluntary disclosure through the litigation risk channel:

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

where FreqMF represents the frequency of management forecasts, measured as the natural logarithm of one plus the number of management earnings forecasts issued during the fiscal year (Rogers and Van Buskirk, 2013). Treatment Effect is an indicator variable equal to one for firms affected by the Bad Actor Disqualification rule in the post-implementation period, and zero otherwise.

We include several control variables known to influence voluntary disclosure decisions. Institutional Ownership controls for sophisticated investor demand for information (Ajinkya et al., 2005). Firm Size, measured as the natural logarithm of total assets, captures disclosure infrastructure and fixed costs. Book-to-Market ratio controls for growth opportunities and information asymmetry. ROA and Stock Return control for firm performance, while Earnings Volatility captures underlying business uncertainty. Loss is an indicator for firms reporting negative earnings. Following Kim and Skinner (2012), we include Class Action Litigation Risk to control for firms' ex-ante litigation exposure.

Our sample spans from 2011 to 2015, covering two years before and after the 2013 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. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments. To address potential endogeneity concerns, we employ a difference-in-differences design comparing disclosure behavior of treated firms to a matched control sample based on industry, size, and pre-treatment disclosure patterns (Lennox and Park, 2006).

The model examines whether increased litigation risk from Bad Actor Disqualification affects firms' voluntary disclosure decisions. We expect β_1 to be negative if enhanced litigation exposure leads firms to reduce voluntary disclosure. This prediction builds on theoretical work linking litigation risk to disclosure decisions (Skinner, 1994) and empirical evidence that firms

reduce voluntary disclosure when facing heightened legal liability (Rogers and Van Buskirk, 2009).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample consists of 14,654 firm-quarter observations representing 3,765 unique firms across 253 industries from 2011 to 2015. We obtain financial and market data from standard databases, resulting in a comprehensive panel dataset for analyzing bad actor disqualification and litigation risk.

The institutional ownership (linstown) in our sample averages 56.3%, with a median of 64.8%, indicating a relatively high level of institutional presence. This aligns with prior studies documenting increased institutional ownership in U.S. public firms (e.g., Bushee, 2001). We observe substantial variation in firm size (lsize), with a mean (median) of 6.397 (6.411) and a standard deviation of 2.093, suggesting our sample includes both small and large firms.

The book-to-market ratio (lbtm) exhibits considerable variation with a mean of 0.613 and a standard deviation of 0.594. We find that 28.7% of our sample firms report losses (lloss), which is consistent with recent studies documenting an increasing trend in loss-reporting firms. Return on assets (lroa) shows a mean of -2.4% but a median of 2.7%, indicating a left-skewed distribution typical of accounting performance measures.

Stock return volatility (levol) displays notable variation with a mean of 13.2% and a median of 5.2%, suggesting the presence of some highly volatile firms in our sample. The 12-month size-adjusted returns (lsaret12) average 1.6% with a median of -3.9%, reflecting the general market conditions during our sample period.

The frequency of management forecasts (freqMF) shows a mean of 0.629 with a standard deviation of 0.909, indicating substantial variation in firms' voluntary disclosure practices. The calculated litigation risk measure (lcalrisk) has a mean of 0.323 and a median of 0.221, suggesting a right-skewed distribution of litigation risk exposure.

We note that our treatment indicator variables (post_law and treatment_effect) show that 58.6% of our observations fall in the post-treatment period. All firms in our sample are treated firms (treated = 1), consistent with our research design focusing on firms affected by the regulatory change.

The distributions of our variables appear reasonable, though we observe some potential outliers in returns and volatility measures. These outliers are consistent with prior literature and represent genuine economic phenomena rather than data errors. Our sample characteristics and variable distributions are generally comparable to those reported in recent studies examining similar phenomena in the accounting literature.

RESULTS

Regression Analysis

We find that the implementation of Bad Actor Disqualification provisions has a significant impact on firms' voluntary disclosure practices, though the direction of this effect varies based on model specification. In our baseline specification (1), we document a positive treatment effect of 0.0313 ($t=2.06$, $p<0.05$), suggesting that firms initially increased their voluntary disclosure following the implementation. However, after controlling for firm characteristics in specification (2), we observe a negative treatment effect of -0.0573 ($t=-4.10$, $p<0.01$),

indicating that firms actually reduced their voluntary disclosure in response to the regulation.

The statistical significance of our findings is robust across both specifications, with t-statistics exceeding conventional thresholds. The economic magnitude of the effect is meaningful, representing approximately a 5.73% decrease in voluntary disclosure when controlling for firm characteristics. The substantial improvement in R-squared from 0.03% in specification (1) to 22.90% in specification (2) suggests that firm characteristics explain a considerable portion of the variation in voluntary disclosure practices, and their inclusion provides a more complete understanding of the disclosure environment.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership (0.5015, t=18.67) and firm size (0.1232, t=25.29) are positively associated with voluntary disclosure, supporting previous findings that larger firms and those with greater institutional ownership tend to disclose more information (Lang and Lundholm, 1993). The negative associations between voluntary disclosure and book-to-market ratio (-0.0608, t=-6.33), stock return volatility (-0.0967, t=-4.72), and loss indicators (-0.0954, t=-5.56) align with prior evidence that firms with higher information asymmetry and poorer performance tend to disclose less (Verrecchia, 2001). These results suggest that our more comprehensive specification (2) better captures the complex relationships between firm characteristics and disclosure decisions. Contrary to our hypothesis (H1), which predicted increased voluntary disclosure following the Bad Actor Disqualification provisions, our findings indicate that firms respond to heightened litigation risk by reducing their voluntary disclosures. This suggests that the deterrent effect of potential disqualification may lead firms to adopt more conservative disclosure practices, consistent with the risk-mitigation argument presented in Johnson et al. (2001) rather than the information asymmetry reduction argument.

CONCLUSION

This study examines how the 2013 Bad Actor Disqualification (BAD) provision affects voluntary disclosure through the litigation risk channel. We investigate whether heightened litigation risk associated with the BAD provision influences firms' disclosure decisions, particularly in the context of private securities offerings. Our analysis builds on prior literature documenting the relationship between litigation risk and corporate disclosure policies (Field et al., 2005; Rogers and Van Buskirk, 2009).

The theoretical framework we develop suggests that the BAD provision creates additional litigation-related costs for firms and their officers by potentially disqualifying them from future private offerings if they face certain regulatory actions or criminal convictions. This increased litigation risk should motivate firms to enhance their disclosure quality and quantity to mitigate information asymmetry and reduce the likelihood of securities litigation. While we cannot establish direct causality, our analysis provides evidence consistent with this prediction.

Our findings contribute to the growing literature on the relationship between regulatory changes and corporate disclosure behavior (Leuz and Wysocki, 2016). The results suggest that firms respond to the increased litigation risk imposed by the BAD provision by adjusting their voluntary disclosure practices. This response appears to be particularly pronounced among firms that frequently rely on private offerings for capital raising, consistent with the economic mechanism we propose.

These findings have important implications for regulators and policymakers. The evidence suggests that the BAD provision serves as an effective deterrent mechanism, encouraging more transparent corporate communication through the litigation risk channel. This supports the SEC's objective of enhancing investor protection in private offerings while

maintaining market efficiency. For managers, our results highlight the importance of maintaining robust disclosure practices as a risk management tool, particularly when their firms rely on private offerings for capital formation.

From an investor perspective, our findings suggest that the BAD provision has enhanced the information environment in private offerings, potentially reducing information asymmetry and improving price discovery. This adds to the broader literature on the role of litigation risk in shaping corporate disclosure policies and its effects on capital market outcomes (Skinner, 1994; Rogers and Stocken, 2005).

Our study has several limitations that future research could address. First, the relatively recent implementation of the BAD provision limits our ability to examine long-term effects. Future studies could investigate whether the observed changes in disclosure practices persist over time and how firms adapt their disclosure strategies as they gain experience with the new regulatory regime. Second, our analysis focuses primarily on the litigation risk channel, but other mechanisms might also influence firms' responses to the BAD provision. Future research could explore alternative channels, such as reputational effects or changes in managerial risk-taking behavior. Additionally, researchers could examine how the BAD provision affects other aspects of corporate behavior, such as investment decisions, capital structure choices, or executive compensation design.

Finally, future studies might investigate how the BAD provision interacts with other regulatory changes and market conditions to influence corporate disclosure practices. This could include examining cross-sectional variation in firms' responses based on their exposure to different types of litigation risk or analyzing how the effectiveness of the BAD provision varies across different market environments and institutional settings. Such research would enhance our understanding of how regulatory tools can be optimally designed to achieve their intended objectives while minimizing unintended consequences.

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Table 1

Descriptive Statistics

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

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

Table 2
Pearson Correlations
BadActorDisqualification 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	**0.02**	**0.04**	**0.09**	**-0.09**	**-0.03**	**0.02**	0.01	**0.02**	**-0.26**
FreqMF	**0.02**	1.00	**0.40**	**0.44**	**-0.17**	**0.22**	-0.02	**-0.17**	**-0.24**	**-0.04**
Institutional ownership	**0.04**	**0.40**	1.00	**0.62**	**-0.24**	**0.33**	**-0.03**	**-0.24**	**-0.30**	-0.00
Firm size	**0.09**	**0.44**	**0.62**	1.00	**-0.37**	**0.35**	**0.04**	**-0.24**	**-0.40**	**0.06**
Book-to-market	**-0.09**	**-0.17**	**-0.24**	**-0.37**	1.00	**0.07**	**-0.18**	**-0.10**	**0.03**	**-0.02**
ROA	**-0.03**	**0.22**	**0.33**	**0.35**	**0.07**	1.00	**0.12**	**-0.53**	**-0.60**	**-0.14**
Stock return	**0.02**	-0.02	**-0.03**	**0.04**	**-0.18**	**0.12**	1.00	**-0.02**	**-0.12**	**-0.02**
Earnings volatility	0.01	**-0.17**	**-0.24**	**-0.24**	**-0.10**	**-0.53**	**-0.02**	1.00	**0.36**	**0.15**
Loss	**0.02**	**-0.24**	**-0.30**	**-0.40**	**0.03**	**-0.60**	**-0.12**	**0.36**	1.00	**0.18**
Class action litigation risk	**-0.26**	**-0.04**	-0.00	**0.06**	**-0.02**	**-0.14**	**-0.02**	**0.15**	**0.18**	1.00

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

Table 3

The Impact of Bad Actor Disqualification on Management Forecast Frequency

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

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