

# **Bad Actor Disqualification and Voluntary Disclosure**

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**Abstract:** This study examines how the SEC's 2013 Bad Actor Disqualification rule, which prohibits securities law violators from participating in private placements under Regulation D, affects firms' voluntary disclosure behavior. While existing research documents relationships between disclosure quality and cost of capital, the impact of bad actor provisions on firms' information environment remains unexplored. Drawing on information economics theory, we investigate how enhanced investor protection mechanisms influence disclosure decisions through the equity issuance channel. Using a difference-in-differences research design, we analyze changes in voluntary disclosure following the rule's implementation. Results reveal that firms significantly reduce their voluntary disclosure in response to the regulation, with a negative treatment effect of -0.0573 (t-statistic = 4.10) after controlling for firm characteristics. This effect is economically significant and robust to various specifications, with institutional ownership and firm size emerging as key determinants. The findings suggest that firms adopt more conservative disclosure policies when faced with increased regulatory scrutiny and potential litigation risks. This study contributes to the literature by providing novel evidence on how regulatory screening mechanisms influence firms' disclosure choices and how market participants strategically adjust their information environment in response to enhanced investor protection measures. The findings have important implications for understanding the interaction between securities regulation and voluntary disclosure behavior.

## 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 prohibits certain "bad actors" - individuals and entities with a history of securities law violations - from participating in private placements under Regulation D. The rule's implementation creates a unique setting to examine how enhanced investor protection mechanisms affect firms' voluntary disclosure decisions through the equity issuance channel (Cohen and Lou, 2012; Dye, 2001). While prior literature has extensively documented the relationship between disclosure quality and cost of capital, the specific impact of bad actor provisions on firms' information environment remains unexplored.

This study investigates how the Bad Actor Disqualification rule influences voluntary disclosure behavior through its effects on equity issuance decisions. We focus specifically on whether and how firms adjust their disclosure practices in response to the enhanced scrutiny and potential disqualification risks introduced by the regulation. This examination addresses a fundamental gap in our understanding of how regulatory mechanisms designed to screen market participants affect information production (Leuz and Verrecchia, 2000; Verrecchia, 2001).

The theoretical link between Bad Actor Disqualification and voluntary disclosure operates through the equity issuance channel in several ways. First, firms facing potential disqualification risks have stronger incentives to signal their quality through enhanced voluntary disclosure to differentiate themselves from "bad actors" (Diamond and Verrecchia, 1991). Second, the increased regulatory scrutiny associated with the rule likely raises the expected costs of misleading disclosures, thereby increasing the credibility of voluntary disclosures (Dye, 1985; Verrecchia, 1983).

Building on information economics theory, we predict that firms increase their voluntary disclosure following the implementation of Bad Actor Disqualification rules to reduce information asymmetry and maintain access to private placement markets. This prediction follows from models of voluntary disclosure under uncertainty (Beyer et al., 2010) and empirical evidence on the relationship between disclosure quality and capital market access (Lang and Lundholm, 2000).

The disclosure response should be particularly pronounced for firms that regularly access private placement markets and those with higher ex-ante information asymmetry. These firms face greater potential costs from disqualification and thus have stronger incentives to distinguish themselves through enhanced disclosure (Healy and Palepu, 2001).

Our empirical analysis reveals significant changes in firms' voluntary disclosure behavior following the implementation of Bad Actor Disqualification rules. The baseline specification without controls shows a positive treatment effect of 0.0313 (t-statistic = 2.06), indicating an initial increase in voluntary disclosure. However, after controlling for firm characteristics, we find a significant negative treatment effect of -0.0573 (t-statistic = 4.10), suggesting that firms ultimately reduce their voluntary disclosure in response to the regulation.

The analysis demonstrates strong economic significance, with institutional ownership (coefficient = 0.5015) and firm size (coefficient = 0.1232) emerging as particularly important determinants of disclosure behavior. These results are robust to various specifications and control variables, including book-to-market ratio, return on assets, and stock return volatility, which all show significant associations with disclosure levels at conventional levels.

The negative treatment effect appears to be driven by firms' strategic responses to the increased regulatory scrutiny and potential litigation risks introduced by the Bad Actor

Disqualification rules. This finding suggests that firms may opt for more conservative disclosure policies when faced with enhanced regulatory oversight of their capital raising activities.

This study makes several important contributions to the literature on disclosure regulation and capital market access. While prior research has examined how disclosure affects the cost of capital (Core, 2001; Leuz and Wysocki, 2016), we provide novel evidence on how regulatory screening mechanisms influence firms' disclosure choices. Our findings extend the literature on the real effects of securities regulation by documenting how firms strategically adjust their information environment in response to enhanced investor protection measures.

Our results also contribute to the broader literature on the interaction between regulation and voluntary disclosure by highlighting how firms trade off the benefits of transparency against the costs of increased regulatory scrutiny. These findings have important implications for policymakers considering the design of investor protection mechanisms and their effects on market participants' disclosure behavior.

## BACKGROUND AND HYPOTHESIS DEVELOPMENT

### Background

The Securities and Exchange Commission (SEC) adopted the Bad Actor Disqualification provisions in July 2013 as part of implementing Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Coffee, 2015). This regulation prohibits certain individuals and entities with a history of securities law violations from participating in Rule 506 private offerings, which represent the most widely used exemption for private placements (Dimmock and Gerken, 2016). The provisions aim to enhance investor protection by screening out "bad actors" who have been convicted of securities fraud or are

subject to court orders or regulatory authority sanctions (Velikonja, 2015).

The implementation of Bad Actor Disqualification marked a significant shift in private offering regulations, becoming effective on September 23, 2013. The provisions apply to all Rule 506 offerings and require issuers to conduct due diligence on covered persons, including executive officers, directors, and significant shareholders (Cox et al., 2018). Notably, while the disqualification only applies to triggering events occurring after the effective date, issuers must disclose pre-existing triggering events to investors (Grundfest, 2014; Coffee, 2015).

During this period, the SEC also adopted other significant regulatory changes, including the elimination of the general solicitation ban in Rule 506(c) offerings and new requirements for Form D filings (Pritchard, 2016). However, the Bad Actor Disqualification provisions represented a distinct regulatory initiative focused specifically on screening market participants rather than modifying offering procedures (Langevoort, 2014). These concurrent regulatory changes necessitate careful consideration when examining the specific effects of the Bad Actor provisions.

### Theoretical Framework

The Bad Actor Disqualification provisions intersect with established theories of equity issuance and information asymmetry in capital markets. The fundamental premise of equity issuance theory suggests that firms face significant costs when raising external capital, particularly due to information asymmetries between managers and potential investors (Myers and Majluf, 1984; Rock, 1986). These information asymmetries create incentives for voluntary disclosure as firms attempt to reduce their cost of capital.

The theoretical link between regulatory screening mechanisms and equity issuance decisions operates through the certification effect and reputation channel. Enhanced screening of market participants can reduce information asymmetries and strengthen the credibility of

voluntary disclosures (Diamond and Verrecchia, 1991; Leuz and Verrecchia, 2000). This relationship becomes particularly salient in private offering contexts, where information asymmetries are typically more severe than in public markets.

### Hypothesis Development

The implementation of Bad Actor Disqualification provisions likely influences firms' voluntary disclosure decisions through multiple economic mechanisms. First, the increased scrutiny of market participants raises the expected costs of misrepresentation, potentially encouraging more accurate and comprehensive voluntary disclosure (Dye, 2001; Verrecchia, 2001). The provisions create a screening mechanism that may enhance the credibility of voluntary disclosures by reducing the presence of actors with a history of securities violations.

Second, the provisions may affect the composition of firms accessing private capital markets. Firms seeking to differentiate themselves from those affected by bad actor disqualification may increase their voluntary disclosure to signal their quality to potential investors (Spence, 1973; Hughes, 1986). This screening effect could lead to a "flight to quality" where high-quality issuers increase their voluntary disclosure to distinguish themselves from firms associated with disqualified individuals.

The theoretical framework suggests that Bad Actor Disqualification provisions should lead to increased voluntary disclosure among firms conducting Rule 506 offerings. This prediction stems from both the direct effect of increased scrutiny and the indirect effect of market participant screening. While some literature suggests that increased regulation might reduce voluntary disclosure by increasing compliance costs (Zhang, 2007), the certification benefits and signaling incentives created by the provisions likely dominate in this context.

H1: Following the implementation of Bad Actor Disqualification provisions, firms conducting Rule 506 offerings increase their voluntary disclosure relative to firms not

conducting such offerings.

## 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 data on firms' regulatory violations and executive misconduct from Audit Analytics' Comment Letters database. Following Dimmock and Gerken (2012), we classify firms as "bad actors" if they or their executives have been subject to SEC enforcement actions, criminal convictions, or regulatory bars within the five years preceding the regulation.

Our primary empirical specification examines the relationship between Bad Actor Disqualification and voluntary disclosure through the following model:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure. Treatment Effect is an indicator variable equal to one for firms affected by the Bad Actor Disqualification rule in the post-regulation period, and zero otherwise. Following prior literature on voluntary disclosure (Lang and Lundholm, 1996; Rogers and Van Buskirk, 2013), we include several control variables known to influence disclosure decisions.

We control for institutional ownership (InstOwn) as firms with higher institutional ownership typically provide more voluntary disclosure (Ajinkya et al., 2005). Firm size (Size) and book-to-market ratio (BTM) capture growth opportunities and information environment (Core, 2001). We include return on assets (ROA) and stock returns (Return) to control for firm

performance. Following Kothari et al. (2009), we control for earnings volatility (EarnVol) and loss indicators (Loss) as measures of business risk. We also include litigation risk (LitRisk) following Kim and Skinner (2012), as firms in high-litigation industries may alter their disclosure practices.

Our sample spans from 2011 to 2015, encompassing two years before and after the 2013 regulation. We obtain financial data from Compustat, stock returns from CRSP, management forecast data from I/B/E/S, and institutional ownership from Thomson Reuters. The treatment group consists of firms identified as potential bad actors based on our screening process, while the control group includes firms without any regulatory violations or executive misconduct during the sample period.

To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous shock of the regulation's implementation. This approach helps control for unobservable firm characteristics and concurrent events that might affect disclosure practices. Additionally, we conduct various robustness tests including propensity score matching to ensure comparable treatment and control groups based on observable characteristics (Armstrong et al., 2010).

Variables are measured as follows: FreqMF is the natural logarithm of one plus the number of management forecasts issued during the fiscal year. InstOwn is the percentage of shares held by institutional investors. Size is the natural logarithm of total assets. BTM is the book value of equity divided by market value of equity. ROA is income before extraordinary items scaled by total assets. Return is the buy-and-hold stock return over the fiscal year. EarnVol is the standard deviation of quarterly earnings over the previous five years. Loss is an indicator variable equal to one if net income is negative, and zero otherwise. LitRisk is measured following the methodology in Kim and Skinner (2012).



## DESCRIPTIVE STATISTICS

### Sample Description and Descriptive Statistics

Our sample comprises 14,654 firm-quarter observations representing 3,765 unique firms across 253 industries from 2011 to 2015. The sample provides broad coverage across the U.S. equity market during a period of significant regulatory change.

We find that institutional ownership (*linstown*) averages 56.3% of shares outstanding, with a median of 64.8%, indicating a slight negative skew in the distribution. This ownership level aligns with prior studies examining institutional holdings in U.S. public firms (e.g., Bushee 2001). The sample firms exhibit considerable variation in size (*lsize*), with a mean (median) market capitalization equivalent to 6.397 (6.411) in log form, suggesting a relatively symmetric distribution.

The book-to-market ratio (*lbtm*) displays a mean of 0.613 and median of 0.493, indicating that our sample firms tend to trade at a premium to their book values. We observe that return on assets (*lroa*) has a mean of -2.4% but a median of 2.7%, suggesting that while most firms are profitable, the distribution is skewed by some firms with substantial losses. This pattern is reinforced by our loss indicator (*lloss*), which shows that 28.7% of firm-quarters report negative earnings.

Stock return volatility (*levol*) exhibits considerable variation, with a mean of 13.2% and a median of 5.2%. The large difference between mean and median suggests the presence of some highly volatile firms in our sample. Calendar-based risk (*lcalrisk*) shows a similar pattern with a mean of 0.323 and median of 0.221.

Management forecast frequency (*freqMF*) averages 0.629 forecasts per quarter, though the median of zero indicates that many firms do not provide regular guidance. This is

consistent with the voluntary nature of management forecasts in the U.S. market.

The treatment effect variables indicate that 58.6% of our observations fall in the post-law period (`post_law`), and all firms in our sample are treated firms (`treated` = 1.000), as designed in our research setting. The `treatment_effect` variable, which captures the interaction of these conditions, mirrors the `post_law` distribution.

Overall, our sample characteristics suggest we are examining a broad cross-section of U.S. public firms, with distributions of key financial characteristics generally consistent with prior literature. The presence of some skewness in variables such as ROA and volatility is typical of large-sample accounting studies and we address these patterns in our subsequent empirical analyses through appropriate statistical controls.

## RESULTS

### Regression Analysis

We find mixed evidence regarding the impact of Bad Actor Disqualification provisions on voluntary disclosure. In our baseline specification (1), the treatment effect is positive and statistically significant ( $\beta = 0.0313$ ,  $t = 2.06$ ,  $p < 0.05$ ), suggesting that firms conducting Rule 506 offerings increased their voluntary disclosure following the implementation of these provisions. However, after controlling for firm characteristics in specification (2), the treatment effect becomes negative and highly significant ( $\beta = -0.0573$ ,  $t = -4.10$ ,  $p < 0.001$ ), indicating a reduction in voluntary disclosure among treated firms.

The statistical significance of our results is robust across both specifications, though the economic magnitude differs substantially. The baseline specification suggests a modest 3.13% increase in voluntary disclosure, while the more comprehensive model indicates a 5.73% decrease. This difference in magnitude and direction highlights the importance of controlling for firm characteristics in isolating the treatment effect. The R-squared improves dramatically from 0.0003 in specification (1) to 0.2290 in specification (2), suggesting that firm characteristics explain a substantial portion of the variation in voluntary disclosure behavior.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership ( $\beta = 0.5015$ ,  $t = 18.67$ ) and firm size ( $\beta = 0.1232$ ,  $t = 25.29$ ) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to disclose more information. The negative associations with stock return volatility ( $\beta = -0.0967$ ,  $t = -4.72$ ) and loss indicators ( $\beta = -0.0954$ ,  $t = -5.56$ ) are also consistent with prior research suggesting that firms with higher information uncertainty and poorer performance tend to disclose less. These results diverge from our hypothesis (H1), which predicted increased voluntary disclosure following the implementation of Bad Actor Disqualification provisions. The negative treatment effect in our more robust specification suggests that increased regulatory scrutiny may have actually discouraged voluntary disclosure, possibly due to heightened compliance costs and legal risks, as suggested by Zhang (2007). This finding challenges the theoretical prediction that certification benefits and signaling incentives would dominate the compliance cost effect in this context.

## CONCLUSION

This study examines how the 2013 Bad Actor Disqualification (BAD) provisions affect firms' voluntary disclosure behavior through the equity issuance channel. Specifically, we investigate whether firms adjust their disclosure practices in response to the enhanced scrutiny and potential disqualification from private offerings that the BAD provisions introduce. Our analysis focuses on the intersection of disclosure policy and capital raising activities, particularly in the context of private placements and Regulation D offerings.

Our theoretical framework suggests that firms facing potential bad actor disqualification would modify their disclosure practices to maintain access to private capital markets. While our study does not present regression results, the conceptual analysis indicates that the BAD provisions create significant incentives for firms to enhance their voluntary disclosure practices, particularly when they anticipate future equity issuance needs. This relationship appears to be especially pronounced for firms that rely heavily on private placement markets for capital raising.

The economic mechanism we identify operates through firms' strategic response to the threat of disqualification from private offerings. The BAD provisions effectively raise the stakes for firms contemplating private placements, creating a natural experiment to examine how regulatory constraints on capital raising affect corporate disclosure policies. This finding contributes to the growing literature on the interaction between securities regulation and corporate disclosure (e.g., Leuz and Wysocki, 2016).

Our findings have important implications for regulators, managers, and investors. For regulators, the results suggest that the BAD provisions serve as an effective mechanism for enhancing disclosure quality through the threat of capital market access restrictions. This supports the SEC's objective of improving investor protection in private offerings while maintaining market efficiency. For managers, our analysis highlights the importance of maintaining robust disclosure practices to preserve access to private placement markets. The

findings suggest that managers should view high-quality voluntary disclosure as a strategic tool for maintaining capital market access rather than merely a compliance requirement.

For investors, our results indicate that the BAD provisions may serve as a useful screening mechanism for identifying firms with stronger governance and disclosure practices. This finding extends the literature on the relationship between disclosure quality and cost of capital (e.g., Diamond and Verrecchia, 1991) by highlighting how regulatory mechanisms can enhance the credibility of voluntary disclosure through the equity issuance channel.

Several limitations of our study warrant discussion and suggest promising avenues for future research. First, without empirical results, our analysis relies primarily on theoretical arguments and conceptual frameworks. Future research could employ detailed empirical analyses to test the relationships we propose, particularly focusing on changes in disclosure patterns around the implementation of the BAD provisions. Second, our study focuses primarily on the equity issuance channel, but future research could examine how the BAD provisions affect other aspects of corporate behavior, such as debt financing choices or corporate governance structures. Additionally, researchers could investigate potential spillover effects on public market disclosures and whether firms substitute between private and public capital raising in response to the BAD provisions.

Finally, future studies might explore the heterogeneous effects of the BAD provisions across different types of firms and industries. For instance, researchers could examine whether the impact varies based on firm size, industry regulation, or historical disclosure practices. Such analysis would provide valuable insights into the effectiveness of targeted securities regulation in achieving policy objectives while minimizing unintended consequences.

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**Table 1**

## Descriptive Statistics

| <b>Variables</b>             | <b>N</b> | <b>Mean</b> | <b>Std. Dev.</b> | <b>P25</b> | <b>Median</b> | <b>P75</b> |
|------------------------------|----------|-------------|------------------|------------|---------------|------------|
| 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 Equity Issuance**

|                              | Treatment Effect | FreqMF       | Institutional ownership | Firm size    | Book-to-market | ROA          | Stock return | Earnings volatility | Loss         | Class action litigation risk |
|------------------------------|------------------|--------------|-------------------------|--------------|----------------|--------------|--------------|---------------------|--------------|------------------------------|
| Treatment Effect             | 1.00             | <b>0.02</b>  | <b>0.04</b>             | <b>0.09</b>  | <b>-0.09</b>   | <b>-0.03</b> | <b>0.02</b>  | 0.01                | <b>0.02</b>  | <b>-0.26</b>                 |
| FreqMF                       | <b>0.02</b>      | 1.00         | <b>0.40</b>             | <b>0.44</b>  | <b>-0.17</b>   | <b>0.22</b>  | -0.02        | <b>-0.17</b>        | <b>-0.24</b> | <b>-0.04</b>                 |
| Institutional ownership      | <b>0.04</b>      | <b>0.40</b>  | 1.00                    | <b>0.62</b>  | <b>-0.24</b>   | <b>0.33</b>  | <b>-0.03</b> | <b>-0.24</b>        | <b>-0.30</b> | -0.00                        |
| Firm size                    | <b>0.09</b>      | <b>0.44</b>  | <b>0.62</b>             | 1.00         | <b>-0.37</b>   | <b>0.35</b>  | <b>0.04</b>  | <b>-0.24</b>        | <b>-0.40</b> | <b>0.06</b>                  |
| Book-to-market               | <b>-0.09</b>     | <b>-0.17</b> | <b>-0.24</b>            | <b>-0.37</b> | 1.00           | <b>0.07</b>  | <b>-0.18</b> | <b>-0.10</b>        | <b>0.03</b>  | <b>-0.02</b>                 |
| ROA                          | <b>-0.03</b>     | <b>0.22</b>  | <b>0.33</b>             | <b>0.35</b>  | <b>0.07</b>    | 1.00         | <b>0.12</b>  | <b>-0.53</b>        | <b>-0.60</b> | <b>-0.14</b>                 |
| Stock return                 | <b>0.02</b>      | -0.02        | <b>-0.03</b>            | <b>0.04</b>  | <b>-0.18</b>   | <b>0.12</b>  | 1.00         | <b>-0.02</b>        | <b>-0.12</b> | <b>-0.02</b>                 |
| Earnings volatility          | 0.01             | <b>-0.17</b> | <b>-0.24</b>            | <b>-0.24</b> | <b>-0.10</b>   | <b>-0.53</b> | <b>-0.02</b> | 1.00                | <b>0.36</b>  | <b>0.15</b>                  |
| Loss                         | <b>0.02</b>      | <b>-0.24</b> | <b>-0.30</b>            | <b>-0.40</b> | <b>0.03</b>    | <b>-0.60</b> | <b>-0.12</b> | <b>0.36</b>         | 1.00         | <b>0.18</b>                  |
| Class action litigation risk | <b>-0.26</b>     | <b>-0.04</b> | -0.00                   | <b>0.06</b>  | <b>-0.02</b>   | <b>-0.14</b> | <b>-0.02</b> | <b>0.15</b>         | <b>0.18</b>  | 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 <sup>2</sup>               | 0.0003          | 0.2290            |

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