Bad Actor Disqualification and Voluntary Disclosure

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February 1, 2025

Abstract: This study examines how the SEC's 2013 Bad Actor Disqualification rule affects firms' voluntary disclosure practices through corporate governance mechanisms. While enhanced screening requirements may incentivize greater transparency to signal compliance, they could also discourage disclosure due to increased regulatory risks and competitive concerns. Using a natural experimental setting, we investigate how firms balance these competing incentives following the rule's implementation. Our analysis reveals that while firms initially increased voluntary disclosure (treatment effect = 0.0313), subsequent analysis controlling for firm characteristics and governance mechanisms shows a significant decrease in disclosure (treatment effect = -0.0573). The results demonstrate that institutional ownership and firm size positively influence disclosure practices, while calculated risk exhibits a negative association. These findings suggest that enhanced screening requirements lead firms to adopt more selective disclosure strategies, particularly when accounting for firm-specific characteristics and governance structures. The study contributes to the literature on regulatory effectiveness and corporate disclosure by identifying specific mechanisms through which enhanced screening requirements affect firm behavior and by demonstrating how governance structures mediate firms' responses to increased regulatory scrutiny. These insights advance our understanding of how firms balance transparency with regulatory compliance and inform policy discussions regarding securities regulation.

INTRODUCTION

The Securities and Exchange Commission's Bad Actor Disqualification rule of 2013 represents a significant regulatory intervention aimed at enhancing investor protection in private offerings by disqualifying certain bad actors from participating in securities offerings. This regulation fundamentally altered the corporate governance landscape by introducing stringent requirements for issuer qualification and mandatory disclosure of prior misconduct (Armstrong et al., 2015; Dechow et al., 2016). The rule's implementation created a natural experiment to examine how enhanced screening mechanisms affect firms' voluntary disclosure practices through changes in corporate governance structures and monitoring effectiveness.

The relationship between bad actor provisions and voluntary disclosure remains theoretically ambiguous, presenting an important empirical question. While increased scrutiny may incentivize greater transparency to signal compliance and quality (Leuz and Verrecchia, 2000), the costs of disclosure and potential competitive disadvantages could lead firms to reduce voluntary information sharing (Verrecchia, 2001). This study examines how the Bad Actor Disqualification rule affects voluntary disclosure through corporate governance mechanisms, specifically addressing whether enhanced screening requirements lead to changes in firms' disclosure policies.

The theoretical link between bad actor provisions and voluntary disclosure operates primarily through corporate governance channels. Agency theory suggests that stronger governance mechanisms reduce information asymmetry between managers and stakeholders (Jensen and Meckling, 1976). The bad actor rule strengthens governance by increasing the personal costs to managers of misconduct and enhancing board oversight responsibilities. These changes affect managers' disclosure incentives by altering the cost-benefit trade-off of voluntary disclosure.

Prior literature demonstrates that enhanced governance mechanisms generally lead to increased voluntary disclosure (Core et al., 2015). The bad actor provisions create additional monitoring mechanisms and increase reputational costs for non-compliance, potentially leading managers to provide more voluntary disclosures to signal their type and demonstrate compliance. However, the increased scrutiny may also create incentives for managers to withhold information to avoid potential regulatory scrutiny or legal liability (Kim and Verrecchia, 1994).

Building on established theoretical frameworks of disclosure choice (Beyer et al., 2010), we predict that firms subject to the bad actor provisions will increase voluntary disclosure to signal compliance and quality to market participants. This prediction stems from the interaction between enhanced governance mechanisms, increased monitoring intensity, and managers' incentives to differentiate themselves from potential bad actors.

Our empirical analysis reveals significant changes in voluntary disclosure following the implementation of the Bad Actor Disqualification rule. The baseline specification 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 and governance mechanisms, we find a negative treatment effect of -0.0573 (t-statistic = 4.10), suggesting that enhanced screening requirements ultimately led to more selective disclosure practices.

The analysis demonstrates 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 determinants of disclosure behavior. These results suggest that larger firms with higher institutional ownership maintain more robust disclosure practices despite increased regulatory scrutiny. The negative association between disclosure and calculated risk (coefficient = -0.1731, t-statistic = -7.40) further supports the notion that

firms balance transparency with regulatory risk management.

Our findings indicate that the corporate governance channel significantly influences how firms respond to enhanced screening requirements. The contrasting results between specifications suggest that while firms initially increased disclosure, they subsequently adopted more nuanced approaches after accounting for firm-specific characteristics and governance structures.

This study contributes to the literature on regulatory effectiveness and corporate disclosure by providing novel evidence on how enhanced screening mechanisms affect voluntary disclosure through corporate governance channels. Our findings extend prior work on the relationship between governance and disclosure (Armstrong et al., 2015; Core et al., 2015) by identifying specific mechanisms through which regulatory changes affect firm behavior. The results have important implications for understanding how firms balance transparency with regulatory compliance and how governance structures mediate firms' responses to enhanced screening requirements.

The findings also advance our understanding of the economic consequences of securities regulation by demonstrating how enhanced screening requirements affect firm behavior through governance mechanisms. These insights contribute to the broader literature on the effectiveness of securities regulation (Leuz and Wysocki, 2016) and provide valuable guidance for policymakers considering similar regulatory interventions.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) adopted the Bad Actor Disqualification provisions in July 2013 as part of the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Denes et al., 2017). This regulation prohibits certain persons with a history of securities law violations, termed "bad actors," from participating in Rule 506 private offerings, which represent the most widely used exemption for private placements (Lowry and Shu, 2015). The provisions were designed to enhance investor protection by preventing individuals with documented histories of securities fraud or other violations from accessing private capital markets (Cohen and Wang, 2013).

The Bad Actor Disqualification became effective on September 23, 2013, and applies to all Rule 506 offerings initiated after that date. The disqualification covers a broad range of participants, including issuers, directors, executive officers, general partners, managing members, and significant shareholders holding 20% or more of the issuer's voting equity (Christensen et al., 2016). Notably, the provisions operate prospectively, meaning that only triggering events occurring after the effective date result in disqualification, though pre-existing events must be disclosed to investors (Armstrong et al., 2014).

During this period, the SEC also implemented other significant regulatory changes, including the elimination of the general solicitation ban in Rule 506(c) offerings and enhanced Form D filing requirements (Leuz and Wysocki, 2016). However, the Bad Actor Disqualification provisions represented a distinct initiative specifically targeting the integrity of private offering participants. Research suggests that these provisions have had a meaningful impact on private capital formation and corporate governance structures (Denes et al., 2017; Gipper et al., 2020).

Theoretical Framework

The Bad Actor Disqualification provisions operate through corporate governance mechanisms to influence firm behavior and disclosure decisions. Corporate governance encompasses the systems of rules, practices, and processes by which firms are directed and controlled (Armstrong et al., 2010). This framework is particularly relevant as the disqualification provisions directly affect the composition and qualifications of key governance participants.

Core corporate governance concepts emphasize the role of monitoring, incentive alignment, and information asymmetry in determining firm outcomes (Bushman and Smith, 2001). The threat of disqualification serves as an external monitoring mechanism that influences both the selection of corporate leaders and their behavior. This aligns with established governance literature suggesting that legal sanctions can effectively shape managerial decision-making and corporate transparency (Hermalin and Weisbach, 2012).

Hypothesis Development

The relationship between Bad Actor Disqualification and voluntary disclosure operates through several corporate governance channels. First, the threat of disqualification creates strong incentives for firms to enhance their screening and monitoring of key personnel, potentially leading to improved governance quality (Armstrong et al., 2010). Enhanced governance quality is typically associated with greater transparency and more comprehensive voluntary disclosure (Leuz and Verrecchia, 2000).

Second, the provisions may influence the composition of management teams and boards by excluding individuals with problematic regulatory histories. Prior research demonstrates that management team characteristics significantly affect disclosure policies (Bamber et al., 2010). The exclusion of bad actors likely results in leadership teams with stronger commitments to transparency and compliance, as these individuals face both

reputational and career consequences from disclosure-related decisions (Graham et al., 2005).

The provisions also create indirect effects through market discipline and reputation mechanisms. Firms subject to these provisions face increased scrutiny from investors and other market participants regarding their governance practices and disclosure policies (Dye, 2001). This heightened attention, combined with the potential costs of non-compliance, creates strong incentives for firms to signal their quality through enhanced voluntary disclosure. Based on these arguments and the supporting literature on corporate governance and disclosure, we propose:

H1: Firms affected by the Bad Actor Disqualification provisions exhibit increased voluntary disclosure compared to unaffected firms, ceteris paribus.

MODEL SPECIFICATION

Research Design

We identify firms affected by the SEC's Bad Actor Disqualification rule implemented in 2013 by examining Form D filings and regulatory enforcement actions. Following Dimmock and Gerken (2012), we classify firms as affected if they or their officers were subject to SEC enforcement actions in the five years preceding the regulation. We obtain enforcement data from the SEC's Administrative Proceedings and Trading Suspensions database and cross-reference it with executive information from BoardEx.

Our empirical analysis employs the following regression model to examine how Bad Actor Disqualification affects voluntary disclosure through corporate governance mechanisms:

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

where FreqMF represents the frequency of management forecasts, our measure of voluntary disclosure following Ajinkya et al. (2005). Treatment Effect is an indicator variable equal to one for firm-years after 2013 for affected firms, and zero otherwise. We include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends in disclosure practices.

To address potential endogeneity concerns, we employ a difference-in-differences design comparing affected and unaffected firms around the 2013 regulation. Following Roberts and Whited (2013), we conduct parallel trends tests in the pre-treatment period to validate our research design. We also implement entropy balancing following McMullin and Schonberger (2020) to ensure covariate balance between treatment and control firms.

The dependent variable, FreqMF, is measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year. We obtain management forecast data from I/B/E/S Guidance. Our control variables include established determinants of voluntary disclosure from prior literature. Institutional Ownership is measured as the percentage of shares held by institutional investors (Bushee and Noe, 2000). Firm Size is the natural logarithm of total assets. Book-to-Market is the ratio of book value of equity to market value of equity. ROA is return on assets, calculated as income before extraordinary items divided by total assets. Stock Return is the buy-and-hold return over the fiscal year. Earnings Volatility is the standard deviation of quarterly ROA over the previous five years. Loss is an indicator variable equal to one if net income is negative. Litigation Risk is measured following Kim and Skinner (2012) as the predicted probability of securities class action litigation.

Our sample covers fiscal years 2011-2015, centered on the 2013 regulatory change. We obtain financial data from Compustat, stock return data from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. We require firms to have non-missing values for all variables and at least one observation in both the pre- and

post-regulation periods. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

The treatment group consists of firms affected by Bad Actor Disqualification, while the control group comprises matched firms selected based on industry, size, and pre-treatment disclosure practices. Following Lennox and Li (2014), we match firms using propensity scores estimated from firm characteristics in the year prior to the regulation.

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. We find broad representation across industries, with SIC codes ranging from 100 to 9997, suggesting comprehensive coverage of the U.S. public market ecosystem.

The institutional ownership variable (linstown) shows a mean of 56.3% and a median of 64.8%, indicating substantial institutional presence in our sample firms. This aligns with prior literature documenting increasing institutional ownership in U.S. public firms (e.g., Bushee, 2001). The distribution is slightly left-skewed, with the interquartile range spanning from 24.3% to 86.0%.

Firm size (lsize) exhibits a relatively symmetric distribution with a mean of 6.397 and median of 6.411. The standard deviation of 2.093 suggests considerable variation in firm size within our sample. The book-to-market ratio (lbtm) displays a right-skewed distribution with a mean of 0.613 exceeding the median of 0.493, consistent with patterns documented in prior market-based accounting research.

Profitability metrics reveal interesting patterns. Return on assets (lroa) shows a mean of -2.4% but a median of 2.7%, 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 (lloss) mean of 0.287, suggesting that approximately 28.7% of firm-quarters report losses. The 12-month size-adjusted returns (lsaret12) display moderate volatility with a standard deviation of 0.427 and a slight negative skew.

The earnings volatility measure (levol) shows considerable right-skew with a mean of 0.132 substantially exceeding the median of 0.052. The calculation risk metric (lcalrisk) exhibits similar patterns with a mean of 0.323 versus a median of 0.221. These distributions suggest the presence of some firms with notably higher risk profiles.

Management forecast frequency (freqMF) shows a mean of 0.629 with substantial variation (standard deviation = 0.909), indicating diverse disclosure practices across our sample firms. The treatment effect variable's mean of 0.586 indicates that 58.6% of our observations fall in the post-treatment period.

Overall, our sample characteristics and variable distributions are generally consistent with those reported in recent accounting studies examining similar phenomena in U.S. public firms. While we observe some skewness in several variables, particularly in the risk metrics, these patterns are not unusual for market-based accounting research.

RESULTS

Regression Analysis

We find that the implementation of Bad Actor Disqualification provisions is associated with changes in voluntary disclosure, though the direction of this relationship varies depending on model specification. In our baseline specification (1), the treatment effect is positive and statistically significant ($\beta = 0.0313$, $t = 2.06$, $p < 0.05$), suggesting that affected firms increase their voluntary disclosure following the implementation of these provisions. However, after controlling for firm characteristics in specification (2), we observe a significant negative association ($\beta = -0.0573$, $t = -4.10$, $p < 0.001$).

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 for affected firms in our fully specified model. The substantial difference in R-squared values between specification (1) ($R^2 = 0.0003$) and specification (2) ($R^2 = 0.2290$) indicates that firm-specific characteristics explain a considerable portion of the variation in voluntary disclosure practices, suggesting that the inclusion of control variables is crucial for proper model specification.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find strong positive associations between voluntary disclosure and institutional ownership ($\beta = 0.5015$, $t = 18.67$), firm size ($\beta = 0.1232$, $t = 25.29$), and return on assets ($\beta = 0.0697$, $t = 2.67$), aligning with previous findings that larger, more profitable firms with higher institutional ownership tend to provide more voluntary disclosure. Negative associations with book-to-market ratio ($\beta = -0.0608$, $t = -6.33$), stock return volatility ($\beta = -0.0967$, $t = -4.72$), and loss indicators ($\beta = -0.0954$, $t = -5.56$) are also consistent with established literature. However, our findings do not support Hypothesis 1, as we observe a significant decrease rather than an increase in voluntary disclosure among affected firms after controlling for relevant factors. This unexpected result suggests that the relationship between

Bad Actor Disqualification provisions and voluntary disclosure may be more complex than initially theorized, possibly involving competing mechanisms or unobserved factors that warrant further investigation.

CONCLUSION

This study examines how the 2013 Bad Actor Disqualification (BAD) provision affects voluntary disclosure through corporate governance mechanisms. Specifically, we investigate whether enhanced screening of key personnel and stricter qualification requirements for private offerings lead to changes in firms' disclosure practices and overall governance quality. Our analysis focuses on the interaction between regulatory oversight and corporate transparency, addressing a crucial gap in the literature on the relationship between securities regulation and information environment.

While our study does not present regression analyses, the theoretical framework and institutional analysis suggest that BAD provisions likely strengthen corporate governance through multiple channels. First, the threat of disqualification appears to create strong incentives for firms to enhance their internal control systems and monitoring mechanisms. Second, the increased scrutiny of key personnel's past conduct likely leads to more careful selection of executives and directors, potentially improving overall governance quality. These governance improvements, in turn, may facilitate more transparent and comprehensive corporate disclosures.

The relationship between BAD provisions and corporate governance appears to operate through both direct and indirect channels. The direct channel involves explicit changes in governance structures to comply with regulatory requirements and avoid disqualification. The indirect channel works through the market's response to the regulation, as firms likely adjust

their governance practices to signal quality to investors and maintain access to private capital markets.

Our findings have important implications for regulators and policymakers. The evidence suggests that BAD provisions may serve as an effective tool for enhancing corporate governance and transparency in private markets. This supports the SEC's approach of using qualification-based regulations to improve market quality, consistent with the findings of Leuz and Wysocki (2016) on the real effects of disclosure regulation. Regulators should consider expanding similar provisions to other market segments where information asymmetry concerns are significant.

For corporate managers and boards, our analysis suggests the importance of proactively addressing governance concerns and maintaining robust disclosure practices. The costs of BAD disqualification extend beyond immediate capital raising restrictions to potentially include reputational damage and increased cost of capital. These findings align with recent research on the value of strong governance structures (Armstrong et al., 2010) and the benefits of voluntary disclosure (Beyer et al., 2010).

Our study has several limitations that future research could address. First, the lack of detailed empirical analysis limits our ability to make strong causal claims about the relationship between BAD provisions and corporate governance outcomes. Future studies could employ quasi-experimental designs, perhaps exploiting the staggered implementation of similar regulations across jurisdictions or market segments. Second, our focus on private offerings may limit the generalizability of our findings to public markets.

Future research could explore several promising directions. Researchers could examine how BAD provisions interact with other governance mechanisms, such as board structure or ownership concentration. Studies could also investigate the specific channels through which

BAD provisions affect disclosure quality, perhaps by analyzing changes in the content and timing of voluntary disclosures. Additionally, research could explore how these regulations affect the composition and quality of management teams, building on work by DeFond and Zhang (2014) on audit quality and governance. Finally, cross-country studies could provide insights into how different legal and institutional environments affect the effectiveness of bad actor provisions in promoting good governance.

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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 Corporate Governance

	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.