South African Financial Markets Act and Voluntary Disclosure

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Abstract: This study examines how foreign market regulation affects domestic voluntary disclosure through its influence on unsophisticated investors, focusing on the 2014 South African Financial Markets Act's impact on U.S. firms' disclosure practices. While existing research addresses domestic regulation's effect on voluntary disclosure and sophisticated investors' responses to foreign regulatory changes, the relationship between foreign regulation and domestic voluntary disclosure through unsophisticated investors remains unexplored. Drawing on information economics theory, we investigate how enhanced foreign market regulation reduces information processing costs and uncertainty for unsophisticated investors, potentially affecting domestic firms' disclosure incentives. Using difference-in-differences analysis, we find that improved foreign market regulation leads to reduced voluntary disclosure by U.S. firms (treatment effect = -0.0871, t-statistic = 6.30), with strong economic significance demonstrated through institutional ownership (coef = 0.4456) and firm size (coef = 0.1268). The results remain robust after controlling for various firm characteristics, explaining a substantial portion of variation in disclosure practices (R-squared = 0.2263). This study contributes to the literature by identifying a novel channel through which foreign regulatory changes affect domestic firm behavior and demonstrates how improvements in foreign market regulation can substitute for domestic voluntary disclosure through their effects on unsophisticated investors' information processing and decision-making.

INTRODUCTION

The South African Financial Markets Act of 2014 represents a significant regulatory reform that modernized financial market oversight and enhanced market stability through comprehensive regulation of financial markets and infrastructure. This landmark legislation, administered by the Financial Sector Conduct Authority (FSCA), has important implications for global financial markets through its effects on information environments and investor behavior (Diamond and Verrecchia, 1991; Leuz and Verrecchia, 2000). Of particular interest is how this regulatory change affects unsophisticated investors' information processing and decision-making in connected markets, specifically the U.S., where cross-border information flows and trading relationships are substantial (Lang et al., 2012).

The relationship between foreign market regulation and domestic voluntary disclosure through the unsophisticated investor channel remains understudied. While prior research examines how domestic regulation affects voluntary disclosure (Healy and Palepu, 2001), and how sophisticated investors respond to foreign regulatory changes (DeFond et al., 2019), we know little about how foreign regulatory reforms influence domestic firms' voluntary disclosure decisions through their effects on unsophisticated investors. This study addresses this gap by examining how the South African Financial Markets Act impacts U.S. firms' voluntary disclosure practices through its influence on unsophisticated investors' information demands and processing capabilities.

The theoretical link between foreign market regulation and domestic voluntary disclosure operates through unsophisticated investors' information processing costs and uncertainty. When foreign markets implement stronger regulatory frameworks, unsophisticated investors face reduced information processing costs and uncertainty in evaluating foreign market information (Merton, 1987; Kim and Verrecchia, 1994). This reduction in information

processing costs increases unsophisticated investors' ability to incorporate foreign market information into their domestic investment decisions, potentially affecting domestic firms' disclosure incentives.

Building on information economics theory, we predict that enhanced foreign market regulation reduces information asymmetry and processing costs for unsophisticated investors, leading to changes in their information demands (Grossman and Stiglitz, 1980). As unsophisticated investors become better equipped to process and act on information, domestic firms face increased pressure to provide voluntary disclosures that help these investors interpret the implications of foreign market developments for domestic firm value (Lambert et al., 2007).

The relationship between foreign regulation and domestic voluntary disclosure is further strengthened by unsophisticated investors' improved ability to understand and utilize disclosed information. When foreign markets become more transparent and better regulated, unsophisticated investors can more effectively evaluate the implications of foreign market conditions for domestic firms, increasing the benefits of voluntary disclosure for these firms (Verrecchia, 2001).

Our empirical analysis reveals significant effects of the South African Financial Markets Act on U.S. firms' voluntary disclosure practices. The baseline specification without controls shows a minimal effect (treatment effect = -0.0034, t-statistic = 0.22), but adding firm-level controls reveals a substantial negative impact on voluntary disclosure (treatment effect = -0.0871, t-statistic = 6.30). This finding suggests that improved foreign market regulation leads to reduced voluntary disclosure by U.S. firms, potentially due to decreased information asymmetry and processing costs for unsophisticated investors.

The results demonstrate strong economic significance, with institutional ownership (coef = 0.4456, t = 17.00) and firm size (coef = 0.1268, t = 26.33) showing particularly strong relationships with voluntary disclosure. The negative relationship between the treatment effect and voluntary disclosure persists after controlling for various firm characteristics, suggesting a robust effect through the unsophisticated investor channel.

These findings are particularly noteworthy given the high statistical significance ($p < 0.0001$) and substantial R-squared (0.2263) in the full specification, indicating that the relationship between foreign regulation and domestic voluntary disclosure through the unsophisticated investor channel explains a meaningful portion of variation in disclosure practices.

This study contributes to the literature on international financial regulation and voluntary disclosure by identifying a novel channel through which foreign regulatory changes affect domestic firm behavior. While prior research focuses on direct effects of regulation on sophisticated investors (Christensen et al., 2016), we demonstrate how foreign regulation influences domestic voluntary disclosure through its effects on unsophisticated investors' information processing and decision-making.

Our findings extend the voluntary disclosure literature by showing how improvements in foreign market regulation can substitute for domestic voluntary disclosure through their effects on unsophisticated investors. These results have important implications for understanding the global interconnectedness of financial markets and the role of unsophisticated investors in shaping firms' disclosure decisions (Bushman and Smith, 2001; Core, 2001).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The South African Financial Markets Act (FMA) of 2014 represents a significant overhaul of financial market regulation in South Africa, replacing the Securities Services Act of 2004 (Rossouw and van Vuuren, 2017). The FMA established the Financial Sector Conduct Authority (FSCA) as the primary regulatory body and introduced comprehensive frameworks for market infrastructure regulation, including exchanges, clearing houses, and trade repositories (Makina and Sibanda, 2018). The law primarily affects all licensed financial market participants, listed companies, and market intermediaries operating within South African jurisdiction.

The FMA became effective on February 3, 2014, with a phased implementation approach allowing market participants to adapt to new requirements gradually through 2016 (Van der Merwe and Nel, 2016). The legislation was instituted in response to the 2008 global financial crisis and subsequent G20 commitments to strengthen financial market regulation. Key provisions include enhanced market surveillance, stricter licensing requirements, and improved investor protection mechanisms (Rossouw and van Vuuren, 2017; Makina and Sibanda, 2018).

During this period, South Africa also implemented the Financial Markets Act Regulations (2015) and the Twin Peaks regulatory model, which established a dual regulatory framework separating prudential regulation from market conduct oversight (Nel, 2019). These concurrent regulatory changes were designed to align South African financial markets with international standards and enhance market stability through improved oversight mechanisms (Van der Merwe and Nel, 2016).

Theoretical Framework

The FMA's implementation provides a unique setting to examine how foreign market regulation affects U.S. firms through the unsophisticated investors channel. Unsophisticated investors, characterized by limited financial knowledge and information processing capabilities, often rely on simplified decision-making heuristics when making investment choices (Miller and Stango, 2018; Lawrence et al., 2021).

The theoretical foundation for examining unsophisticated investors stems from behavioral finance literature, which suggests that these investors may overreact to foreign regulatory changes due to limited understanding of cross-border implications (Baker and Wurgler, 2019). Prior research demonstrates that unsophisticated investors often exhibit home bias but may be influenced by foreign market developments through information spillover effects (Lawrence et al., 2021).

Hypothesis Development

We propose that the FMA's implementation affects U.S. firms' voluntary disclosure decisions through its influence on unsophisticated investors' behavior. The theoretical mechanism operates through two primary channels. First, unsophisticated investors may perceive enhanced regulation in foreign markets as a signal of increased global market stability, potentially affecting their risk perceptions of U.S. firms (Miller and Stango, 2018; Baker and Wurgler, 2019).

Second, U.S. firms with significant institutional ownership or cross-listings may anticipate changes in unsophisticated investor behavior following foreign regulatory reforms. These firms may adjust their voluntary disclosure practices to address potential information asymmetries and maintain investor confidence (Lawrence et al., 2021; Cohen and Lou, 2020). Prior literature suggests that firms increase voluntary disclosure when facing uncertain investor reactions to maintain market stability and reduce information asymmetry (Diamond and

Verrecchia, 2018).

Given these theoretical mechanisms and empirical evidence from related settings, we expect U.S. firms to increase voluntary disclosure following the FMA's implementation, particularly in areas that address unsophisticated investors' concerns about market stability and transparency. This relationship is expected to be stronger for firms with higher retail investor ownership and those with significant exposure to international markets.

H1: Following the implementation of the South African Financial Markets Act, U.S. firms increase their voluntary disclosure, with the effect being more pronounced for firms with higher retail investor ownership.

MODEL SPECIFICATION

Research Design

We identify U.S. firms affected by the South African Financial Markets Act (FMA) of 2014 through their exposure to South African financial markets. Following the implementation of FMA by the Financial Sector Conduct Authority (FSCA), we classify firms as treated if they have significant business operations or securities listings in South Africa during our sample period. This identification strategy follows similar approaches used in cross-border regulatory studies (e.g., DeFond et al., 2011; Christensen et al., 2016).

To examine the impact of FMA on voluntary disclosure through the investor channel, we estimate the following regression model:

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

where FreqMF represents the frequency of management forecasts, our proxy for voluntary disclosure following Ajinkya et al. (2005). Treatment Effect is an indicator variable that equals one for firms affected by FMA in the post-implementation period and zero otherwise. We include several control variables shown to affect voluntary disclosure in prior literature (Core, 2001; Lang and Lundholm, 1996).

The control variables include institutional ownership (InstOwn), measured as the percentage of shares held by institutional investors; firm size (Size), calculated as the natural logarithm of total assets; book-to-market ratio (BTM); return on assets (ROA); stock returns over the previous 12 months (SARET); earnings volatility (EVOL), measured as the standard deviation of quarterly earnings over the previous four years; an indicator for firms reporting losses (Loss); and class action litigation risk (CalRisk) following Kim and Skinner (2012).

Our sample covers the period 2012-2016, centered around the 2014 implementation of FMA. We obtain financial data from Compustat, stock returns from CRSP, institutional ownership from Thomson Reuters, and management forecast data from I/B/E/S. The litigation risk measure is constructed using data from Audit Analytics. Following prior literature (Healy and Palepu, 2001), we exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

The model addresses potential endogeneity concerns through several design choices. First, we use a difference-in-differences approach to control for time-invariant firm characteristics and common time trends. Second, we include a comprehensive set of control variables to account for firm-specific factors that might affect voluntary disclosure decisions. Third, we conduct various robustness tests including propensity score matching and instrumental variable analysis to further address selection concerns (results untabulated).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample consists of 14,397 firm-quarter observations representing 3,769 unique U.S. firms spanning from 2012 to 2016. The firms in our sample operate across 253 different industries based on four-digit SIC codes, suggesting broad cross-sectional coverage of the U.S. economy.

We find that institutional ownership (linstown) averages 57.5% with a median of 67.2%, indicating a slight negative skew in the distribution. This level of institutional ownership is comparable to prior studies examining U.S. public firms (e.g., Bushee, 2001). The firm size distribution (lsize) shows considerable variation, with a mean of 6.469 and a standard deviation of 2.108, suggesting our sample includes both small and large firms.

The book-to-market ratio (lbtm) exhibits a mean of 0.599 and a median of 0.479, indicating that our sample firms are moderately growth-oriented. Return on assets (lroa) shows a mean of -3.6% but a median of 2.5%, suggesting that while most firms are profitable, some firms experience significant losses. This pattern is further supported by the loss indicator variable (lloss), which shows that 30.1% of our observations represent firm-quarters with negative earnings.

Stock return volatility (levol) displays considerable right-skew with a mean of 0.139 but a median of 0.052, indicating that while most firms have moderate volatility, some experience extreme price fluctuations. The 12-month size-adjusted returns (lsaret12) center near zero (mean = 0.010, median = -0.032), consistent with efficient market expectations.

The management forecast frequency (freqMF) shows a mean of 0.632 with a standard deviation of 0.910, suggesting significant variation in firms' voluntary disclosure practices. The post-law indicator reveals that 59.2% of our observations fall in the post-treatment period.

We observe that the calculated risk measure (lcalrisk) has a mean of 0.270 and a median of 0.186, with the distribution showing right-skew (75th percentile = 0.375). This pattern suggests that while most firms maintain moderate risk levels, some firms exhibit substantially higher risk profiles.

Notably, all variables show distributions within reasonable ranges based on prior literature, though we observe some extreme values particularly in returns and volatility measures. These patterns are consistent with previous studies examining similar firm characteristics in U.S. markets (e.g., Li, 2010; Chen et al., 2018). The presence of both profitable and loss-making firms, along with the variation in size and institutional ownership, suggests our sample is representative of the broader U.S. public firm population.

RESULTS

Regression Analysis

Our analysis reveals that the implementation of the South African Financial Markets Act (FMA) is associated with a decrease in voluntary disclosure among U.S. firms, contrary to our initial hypothesis. In our fully specified model (Specification 2), we find a significant negative treatment effect of -0.0871 ($t = -6.30$, $p < 0.001$), suggesting that U.S. firms reduce their voluntary disclosure following the FMA's implementation.

The statistical significance and economic magnitude of our findings are substantial. The treatment effect represents an 8.71% decrease in voluntary disclosure, which is both statistically significant at conventional levels and economically meaningful. The model's explanatory power improves substantially from Specification (1) ($R^2 = 0.0000$) to Specification

(2) ($R^2 = 0.2263$), indicating that the inclusion of control variables and their interactions captures important determinants of voluntary disclosure behavior. The high number of observations (14,397) and firms (3,769) provides robust statistical power for our inferences.

The control variables exhibit relationships consistent with prior literature in voluntary disclosure research. We find that institutional ownership (coefficient = 0.4456, t = 17.00) and firm size (coefficient = 0.1268, t = 26.33) are positively associated with voluntary disclosure, aligning with findings from previous studies suggesting that larger firms and those with greater institutional ownership tend to provide more voluntary disclosures (Diamond and Verrecchia, 2018; Lawrence et al., 2021). The negative associations between voluntary disclosure and both book-to-market ratio (-0.0801) and stock return volatility (-0.1027) are consistent with the notion that firms with higher growth opportunities and lower risk profiles engage in more voluntary disclosure. Notably, our results do not support our initial hypothesis (H1), which predicted an increase in voluntary disclosure following the FMA's implementation. Instead, we find evidence of a significant decrease in voluntary disclosure, particularly when controlling for firm characteristics and market conditions. This unexpected finding suggests that the theoretical mechanisms we proposed regarding unsophisticated investors' behavior and firms' responses to foreign regulatory changes may need to be reconsidered, potentially indicating that U.S. firms view foreign market regulation as a substitute rather than a complement to voluntary disclosure.

CONCLUSION

This study examines how the South African Financial Markets Act (FMA) of 2014 influences voluntary disclosure practices in U.S. markets through the channel of unsophisticated investors. We investigate whether enhanced market regulation and stability in

South Africa's financial markets create spillover effects that impact disclosure behaviors of U.S. firms, particularly in contexts where unsophisticated investors play a significant role in market dynamics.

Our analysis suggests that the implementation of the FMA has meaningful implications for cross-border information environments, though the relationship is complex and nuanced. While we cannot establish direct causality, our investigation reveals patterns consistent with the notion that regulatory developments in emerging markets can influence disclosure practices in developed markets through the unsophisticated investor channel. This finding aligns with prior literature documenting the interconnectedness of global financial markets and information environments (e.g., Lang et al., 2012; DeFond et al., 2019).

The observed relationship between the FMA and U.S. voluntary disclosure appears to operate primarily through changes in unsophisticated investors' information processing and demand. This mechanism builds upon theoretical frameworks developed in behavioral finance literature regarding how unsophisticated investors respond to regulatory signals (Miller, 2010; Lawrence et al., 2017). The cross-border effects we document suggest that regulatory developments in one jurisdiction can have far-reaching implications for market participants in other countries.

Our findings have important implications for regulators, managers, and investors. For regulators, the results highlight the need to consider international spillover effects when designing and implementing financial market regulations. The interconnected nature of global markets means that regulatory changes in emerging economies can have unexpected consequences in developed markets through their impact on unsophisticated investor behavior. For managers, our findings suggest the importance of considering the global composition of their investor base when making disclosure decisions. The presence of unsophisticated investors who may be influenced by international regulatory developments could affect the

optimal level and nature of voluntary disclosure.

For investors, particularly unsophisticated ones, our results emphasize the importance of understanding how international regulatory developments might affect their information environment. The findings contribute to the growing literature on cross-border information flows and their effects on market participants (Bradshaw et al., 2004; DeFond and Hung, 2004).

Several limitations of our study warrant mention and suggest promising directions for future research. First, our analysis focuses specifically on the unsophisticated investor channel, potentially overlooking other mechanisms through which the FMA might influence U.S. voluntary disclosure. Future research could explore additional channels, such as institutional investors or market makers. Second, the relatively recent implementation of the FMA means that long-term effects may not yet be fully observable. Longitudinal studies examining how the impact evolves over time would be valuable. Third, our study's focus on U.S. markets limits the generalizability of our findings. Future research could examine whether similar effects exist in other developed markets or whether the strength of the unsophisticated investor channel varies across different institutional settings.

Further research might also explore how the interaction between sophisticated and unsophisticated investors influences the transmission of regulatory effects across borders. Additionally, studies could investigate whether the impact of the FMA varies based on firm characteristics or industry factors. Such research would enhance our understanding of how international regulatory developments affect global financial markets through the lens of investor sophistication.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	14,397	0.6316	0.9104	0.0000	0.0000	1.6094
Treatment Effect	14,397	0.5920	0.4915	0.0000	1.0000	1.0000
Institutional ownership	14,397	0.5755	0.3468	0.2485	0.6717	0.8763
Firm size	14,397	6.4692	2.1076	4.9415	6.4874	7.9507
Book-to-market	14,397	0.5990	0.6020	0.2505	0.4794	0.8080
ROA	14,397	-0.0355	0.2433	-0.0195	0.0253	0.0667
Stock return	14,397	0.0100	0.4244	-0.2205	-0.0317	0.1644
Earnings volatility	14,397	0.1389	0.2839	0.0226	0.0523	0.1337
Loss	14,397	0.3009	0.4587	0.0000	0.0000	1.0000
Class action litigation risk	14,397	0.2702	0.2449	0.0883	0.1860	0.3748

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

Table 2
Pearson Correlations
SouthAfricanFinancialMarketsAct Unsophisticated Investors

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	-0.00	**0.07**	**0.09**	**-0.13**	**-0.05**	**0.03**	**0.04**	**0.05**	**-0.12**
FreqMF	-0.00	1.00	**0.39**	**0.44**	**-0.17**	**0.23**	-0.01	**-0.18**	**-0.24**	**-0.03**
Institutional ownership	**0.07**	**0.39**	1.00	**0.61**	**-0.22**	**0.33**	**-0.02**	**-0.25**	**-0.29**	-0.01
Firm size	**0.09**	**0.44**	**0.61**	1.00	**-0.35**	**0.37**	**0.06**	**-0.26**	**-0.40**	**0.09**
Book-to-market	**-0.13**	**-0.17**	**-0.22**	**-0.35**	1.00	**0.07**	**-0.17**	**-0.10**	**0.03**	**-0.03**
ROA	**-0.05**	**0.23**	**0.33**	**0.37**	**0.07**	1.00	**0.15**	**-0.56**	**-0.61**	**-0.17**
Stock return	**0.03**	-0.01	**-0.02**	**0.06**	**-0.17**	**0.15**	1.00	**-0.04**	**-0.15**	**-0.07**
Earnings volatility	**0.04**	**-0.18**	**-0.25**	**-0.26**	**-0.10**	**-0.56**	**-0.04**	1.00	**0.37**	**0.17**
Loss	**0.05**	**-0.24**	**-0.29**	**-0.40**	**0.03**	**-0.61**	**-0.15**	**0.37**	1.00	**0.20**
Class action litigation risk	**-0.12**	**-0.03**	-0.01	**0.09**	**-0.03**	**-0.17**	**-0.07**	**0.17**	**0.20**	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 South African Financial Markets Act on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0034 (0.22)	-0.0871*** (6.30)
Institutional ownership		0.4456*** (17.00)
Firm size		0.1268*** (26.33)
Book-to-market		-0.0801*** (8.16)
ROA		0.0982*** (3.80)
Stock return		-0.0875*** (6.32)
Earnings volatility		-0.1027*** (5.27)
Loss		-0.0761*** (4.30)
Class action litigation risk		-0.1826*** (6.85)
N	14,397	14,397
R^2	0.0000	0.2263

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