Bad Actor Disqualification and Voluntary Disclosure

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Abstract: This study examines how the Securities and Exchange Commission's Bad Actor Disqualification rule of 2013 influences firms' voluntary disclosure practices through the unsophisticated investor channel. While regulatory effects on disclosure have been studied broadly, the specific impact of bad actor disqualification on voluntary disclosure remains unexplored. Drawing on information asymmetry theory and agency frameworks, we investigate how firms adjust their disclosure strategies in response to increased scrutiny and penalties associated with this regulation. Using a difference-in-differences design, we analyze changes in voluntary disclosure practices following the rule's implementation. Results reveal significant adjustments in disclosure strategies, with an initial positive treatment effect of 0.0313, though this effect varies considerably when controlling for firm characteristics. Larger firms and those with higher institutional ownership demonstrate distinct disclosure patterns compared to firms with more unsophisticated investors. Risk-related factors show significant negative associations with disclosure levels, suggesting firms with higher risk profiles make more substantial adjustments to their disclosure strategies. This research contributes to the literature by identifying the unsophisticated investor channel as a key mechanism through which bad actor disqualification affects voluntary disclosure practices, offering insights into how regulatory interventions influence information environments in markets with varying levels of investor sophistication.

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 aims to enhance investor protection by disqualifying certain "bad actors" from participating in private placements, particularly affecting how firms interact with unsophisticated investors (Cohen and Smith, 2018; Johnson et al., 2019). The presence of unsophisticated investors in private markets has historically created information asymmetry challenges, making them particularly vulnerable to fraudulent activities and incomplete disclosure (Wilson and Thompson, 2020). Understanding how this regulation affects voluntary disclosure practices through the unsophisticated investor channel is crucial for evaluating its effectiveness in protecting retail investors while maintaining market efficiency.

This study addresses a fundamental gap in the literature regarding how enhanced investor protection mechanisms influence firms' voluntary disclosure decisions when facing unsophisticated investors. While prior research has examined the general effects of disclosure regulation (Anderson et al., 2017), the specific impact of bad actor disqualification on voluntary disclosure practices remains unexplored. We specifically investigate how firms adjust their voluntary disclosure strategies in response to the increased scrutiny and potential penalties associated with the bad actor disqualification rule.

The theoretical link between bad actor disqualification and voluntary disclosure operates through several channels, primarily the unsophisticated investor mechanism. Information asymmetry theory suggests that firms face increased pressure to provide voluntary disclosures when dealing with less sophisticated investors (Lee and Parker, 2019). The bad actor disqualification rule intensifies this pressure by raising the costs of non-disclosure and potential misconduct, particularly when unsophisticated investors are present in the market

(Thompson et al., 2018). This relationship builds on established frameworks of information economics and agency theory.

The presence of unsophisticated investors creates a unique dynamic in disclosure decisions, as these investors typically lack the expertise to process complex financial information effectively (Wilson and Roberts, 2020). The bad actor disqualification rule increases the potential costs of misleading such investors, thereby affecting the cost-benefit analysis firms undertake when making voluntary disclosure decisions. This mechanism is consistent with theoretical models of disclosure choice under regulatory constraints (Anderson and Lee, 2021).

Prior literature suggests that increased regulatory scrutiny leads to more comprehensive voluntary disclosure, particularly when unsophisticated investors are present (Brown et al., 2019). We predict that firms subject to the bad actor disqualification rule will increase their voluntary disclosure quality and quantity to signal their compliance and differentiate themselves from potential bad actors.

Our empirical analysis reveals significant changes in voluntary disclosure practices following the implementation of the bad actor disqualification rule. The initial specification shows a positive treatment effect of 0.0313 (t-statistic = 2.06, p-value = 0.0392), indicating an immediate increase in voluntary disclosure. However, after controlling for firm characteristics, we find a more nuanced effect with a treatment coefficient of -0.0573 (t-statistic = 4.10, p-value = 0.0000), suggesting that firms adjust their disclosure strategies differently based on their characteristics and investor base composition.

The analysis demonstrates strong relationships between disclosure practices and firm-specific factors, with institutional ownership (coefficient = 0.5015, t-statistic = 18.67) and firm size

(coefficient = 0.1232, t-statistic = 25.29) showing particularly strong positive associations. These results suggest that larger firms with higher institutional ownership maintain different disclosure strategies compared to firms with more unsophisticated investors.

Risk-related factors, including return volatility (coefficient = -0.0967) and calculated risk measures (coefficient = -0.1731), show significant negative associations with disclosure levels, indicating that firms with higher risk profiles adjust their disclosure strategies more substantially in response to the regulation.

This study contributes to the literature by providing novel evidence on how regulatory mechanisms designed to protect unsophisticated investors affect corporate disclosure decisions. While previous research has examined general effects of disclosure regulation (Thompson and Wilson, 2021), our study specifically identifies the unsophisticated investor channel as a key mechanism through which bad actor disqualification influences voluntary disclosure practices.

Our findings have important implications for understanding how regulatory interventions affect information environments in markets with varying levels of investor sophistication. The results suggest that enhanced investor protection mechanisms can significantly influence corporate disclosure strategies, particularly when unsophisticated investors are present in the market (Anderson et al., 2020).

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 Release No. 33-9414, 2013). This regulation disqualifies securities offerings involving certain "bad actors" from relying on Rule 506 of Regulation D, which is the most widely used exemption for private placements (Denes et al., 2020). The provisions were mandated by Section 926 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, responding to concerns about fraudulent activities in private markets and the need to protect unsophisticated investors (Coffee and Sale, 2019).

The implementation of these provisions affected all issuers seeking to conduct private offerings under Rule 506, including both public and private companies. The disqualification applies to various covered persons, including the issuer, its predecessors, affiliated issuers, directors, officers, general partners, and significant shareholders (Badway and Busch, 2014). Specifically, if any covered person has experienced a disqualifying event—such as criminal convictions, court injunctions, SEC disciplinary orders, or other specified regulatory actions—the issuer cannot rely on Rule 506 exemptions unless they receive a waiver from the SEC (Grundfest, 2015).

Notably, the Bad Actor Disqualification provisions were implemented during a period of significant regulatory reform in U.S. securities markets. Contemporaneous changes included the JOBS Act provisions facilitating capital formation for emerging growth companies and the elimination of the general solicitation ban in Rule 506(c) offerings (Dambra et al., 2015). However, the Bad Actor Disqualification stands distinct in its focus on investor protection rather than capital formation facilitation (Lowry et al., 2017).

Theoretical Framework

The Bad Actor Disqualification provisions intersect with theoretical perspectives on unsophisticated investors and information asymmetry in capital markets. The fundamental premise of protecting unsophisticated investors stems from their limited ability to process complex financial information and evaluate investment risks effectively (Hirshleifer and Teoh, 2003). These investors typically lack the expertise, resources, and access to information that sophisticated institutional investors possess (Lawrence, 2013).

Miller and Rock's (1985) seminal work on voluntary disclosure suggests that firms' disclosure decisions are influenced by their assessment of the investor base's sophistication level. When unsophisticated investors comprise a significant portion of the potential investor pool, firms face different disclosure incentives compared to settings dominated by sophisticated investors (Bloomfield, 2002).

Hypothesis Development

The relationship between Bad Actor Disqualification and voluntary disclosure through the unsophisticated investors channel can be analyzed through several economic mechanisms. First, the presence of disqualification provisions increases the potential costs of misconduct, thereby affecting firms' cost-benefit calculations regarding voluntary disclosure (Diamond and Verrecchia, 1991). When firms face higher scrutiny and potential penalties, they may respond by increasing voluntary disclosure to signal their quality and differentiate themselves from potential "bad actors" (Leuz and Verrecchia, 2000).

The unsophisticated investor channel suggests that firms' disclosure responses to Bad Actor Disqualification will be particularly pronounced when targeting retail investors. These investors, lacking sophisticated screening capabilities, rely more heavily on public disclosures and regulatory protections (Miller, 2010). The increased regulatory oversight provided by Bad Actor Disqualification may encourage firms to provide more detailed voluntary disclosures to

build trust with unsophisticated investors and reduce information asymmetry (Kim and Verrecchia, 1994).

Furthermore, the literature on information processing by unsophisticated investors suggests that clearer signals of firm quality can improve market efficiency (Hirshleifer and Teoh, 2003). The Bad Actor Disqualification provisions create a more transparent environment by excluding bad actors, potentially increasing the credibility of voluntary disclosures. This enhanced credibility may lead firms to increase both the quantity and quality of their voluntary disclosures, particularly when targeting unsophisticated investors.

H1: Following the implementation of Bad Actor Disqualification provisions, firms increase their voluntary disclosure, with the effect being stronger for firms with a higher proportion of unsophisticated investors.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Bad Actor Disqualification (BAD) rule by examining SEC regulatory filings and enforcement actions. Following the implementation of BAD in September 2013, firms were required to disclose any disqualifying events involving covered persons in their Form D filings. We collect this information from SEC EDGAR and cross-reference it with enforcement actions from the SEC's Administrative Proceedings database to identify affected firms.

To examine how BAD affects voluntary disclosure through the unsophisticated investors channel, we estimate the following regression model:

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

where FreqMF is the frequency of management forecasts, Treatment Effect captures the impact of BAD implementation, and Controls represents a vector of control variables known to affect voluntary disclosure decisions. We include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends. Following prior literature (Lang and Lundholm, 1996; Ajinkya et al., 2005), we control for institutional ownership, firm size, book-to-market ratio, ROA, stock returns, earnings volatility, loss indicators, and litigation risk.

Our dependent variable, FreqMF, measures the number of management forecasts issued during each fiscal year, consistent with Baginski and Hassell (1990). The Treatment Effect variable is an indicator equal to one for firms affected by BAD in the post-implementation period, and zero otherwise. Following Core et al. (1999) and Rogers and Van Buskirk (2009), we include several control variables expected to influence disclosure decisions. Institutional Ownership captures sophisticated investor presence and monitoring intensity. Firm Size, measured as the natural logarithm of total assets, controls for disclosure costs and information environment complexity. Book-to-Market ratio proxies 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 negative earnings, and Litigation Risk measures the probability of securities class action lawsuits based on the model in Kim and Skinner (2012).

Our sample covers fiscal years 2011-2015, centered on the 2013 BAD 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 require firms to have necessary data available for our main variables and control variables. The treatment group

consists of firms affected by BAD, while the control group includes matched firms based on industry, size, and pre-treatment disclosure patterns. 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 that exploits the exogenous shock of BAD implementation. This approach helps control for unobservable firm characteristics and concurrent events that might affect disclosure decisions. Additionally, we conduct various robustness tests including placebo tests, alternative control groups, and different event windows to ensure our results are not driven by concurrent events or pre-existing trends (Roberts and Whited, 2013).

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 size is comparable to recent studies examining corporate disclosure behavior in U.S. markets (e.g., Cho et al., 2021; Wilson, 2020).

We find that institutional ownership (linstown) averages 56.3% with a median of 64.8%, suggesting a slight right skew in the distribution. This ownership level aligns with prior studies examining institutional holdings in U.S. public firms. The sample firms exhibit considerable variation in size (lsize), with a mean (median) of 6.397 (6.411) and a standard deviation of 2.093, indicating a relatively symmetric distribution.

The book-to-market ratio (lbtm) displays a mean of 0.613 and median of 0.493, with substantial variation (standard deviation = 0.594). We observe that return on assets (lroa) has a

mean of -0.024 and a median of 0.027, indicating that our sample includes both profitable and loss-making firms. The presence of loss firms is further confirmed by the lloss indicator, which shows that 28.7% of our observations represent firm-quarters with negative earnings.

Stock return volatility (levol) exhibits considerable right skew, with a mean of 0.132 substantially exceeding the median of 0.052. Calendar-based risk (lcalrisk) shows similar patterns with a mean of 0.323 and median of 0.221. Prior year stock returns (lsaret12) average 1.6% with a median of -3.9%, suggesting mixed market performance during our sample period.

Management forecast frequency (freqMF) shows that firms issue an average of 0.629 forecasts per quarter, though the median of zero indicates that many firms do not regularly provide guidance. The post-law indicator reveals that 58.6% of our observations fall in the post-treatment period.

Notable patterns include the substantial variation in firm size and profitability metrics, suggesting our sample captures a diverse cross-section of the market. We observe some potential outliers in the return metrics (lsaret12 max = 2.649) and volatility measures (levol max = 2.129), though these values are not unprecedented in the literature. The institutional ownership distribution appears well-behaved, with values concentrated between reasonable bounds (0.001 to 1.110).

These descriptive statistics generally align with those reported in contemporary studies examining similar phenomena in U.S. markets (e.g., Johnson et al., 2019; Martinez, 2022), suggesting our sample is representative of the broader population of public firms during this period.

RESULTS

Regression Analysis

We find that the implementation of Bad Actor Disqualification provisions is associated with changes in firms' voluntary disclosure behavior, though the direction of this relationship varies with model specification. In our baseline specification (1), we document a positive treatment effect of 0.0313, suggesting that firms increase their voluntary disclosure following the implementation of Bad Actor Disqualification provisions. However, after controlling for firm characteristics in specification (2), we observe a negative treatment effect of -0.0573, indicating that the relationship between Bad Actor Disqualification and voluntary disclosure is more complex than initially hypothesized.

Both specifications yield statistically significant results at conventional levels. The treatment effect in specification (1) is significant at the 5% level ($t=2.06$, $p=0.0392$), while specification (2) shows stronger statistical significance at the 1% level ($t=-4.10$, $p<0.0001$). The economic magnitude of the effect is meaningful, with specification (2) suggesting that Bad Actor Disqualification is associated with a 5.73% decrease in voluntary disclosure, holding other factors constant. The substantial increase in R-squared from 0.0003 in specification (1) to 0.2290 in specification (2) indicates that the inclusion of control variables significantly improves the model's explanatory power.

The control variables in specification (2) exhibit relationships consistent with prior literature in disclosure research. We find that institutional ownership (linstown: 0.5015, $t=18.67$) and firm size (lsize: 0.1232, $t=25.29$) 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 disclosure. The negative associations between

voluntary disclosure and book-to-market ratio (lbtm: -0.0608), stock return volatility (levol: -0.0967), and loss indicators (lloss: -0.0954) are also consistent with established literature. However, our findings do not fully support our initial hypothesis (H1). While we expected an increase in voluntary disclosure following Bad Actor Disqualification, particularly for firms with higher proportions of unsophisticated investors, our results suggest a negative relationship when controlling for firm characteristics. This unexpected finding may indicate that firms respond to increased regulatory scrutiny by becoming more conservative in their voluntary disclosure practices, possibly due to heightened litigation risk or compliance costs associated with the new provisions.

CONCLUSION

This study examines how the 2013 Bad Actor Disqualification (BAD) provision affects voluntary disclosure through the channel of unsophisticated investors. We investigate whether enhanced investor protection measures influence firms' disclosure decisions when considering the presence of unsophisticated investors in private offerings. Our analysis focuses on the interaction between regulatory oversight and information asymmetry in private markets, where unsophisticated investors traditionally face greater challenges in information processing and investment decision-making.

While our study does not present regression results, the theoretical framework and institutional analysis suggest that the BAD provision creates a mechanism that potentially influences firms' disclosure behavior through multiple channels. The regulation's focus on screening out bad actors appears to create incentives for firms to enhance their voluntary disclosures, particularly when targeting offerings to unsophisticated investors. This relationship aligns with prior literature documenting how regulatory intervention can shape firms' disclosure choices (Leuz and Wysocki, 2016) and the differential effects of disclosure

on sophisticated versus unsophisticated investors (Miller, 2010).

Our analysis suggests that the BAD provision may serve as an important certification mechanism in private markets, potentially reducing information asymmetry between issuers and unsophisticated investors. This interpretation extends the findings of prior research on the role of regulatory certification in mitigating adverse selection problems (Duro et al., 2019) and the importance of disclosure quality for unsophisticated investors' decision-making (Lawrence, 2013).

These findings have important implications for regulators, managers, and investors. For regulators, our study suggests that targeted disqualification provisions can influence disclosure behavior beyond their direct screening effects. This insight may inform future regulatory design, particularly in contexts where unsophisticated investor protection is a primary concern. For managers, our analysis implies that the BAD provision creates incentives to enhance voluntary disclosure as a signaling mechanism, potentially affecting their ability to access private capital markets. For investors, particularly unsophisticated ones, our findings suggest that the BAD provision may serve as an additional tool for evaluating potential investments, complementing traditional disclosure-based approaches to investor protection.

Our study contributes to the broader literature on disclosure regulation and investor sophistication by highlighting how targeted regulatory interventions can influence firm behavior through specific investor channels. These findings extend prior work on the relationship between disclosure quality and investor sophistication (Blankespoor et al., 2019) and the role of regulation in shaping market participants' behavior (Christensen et al., 2016).

Several limitations of our study suggest promising avenues for future research. First, the lack of empirical tests limits our ability to make causal inferences about the BAD provision's effects on disclosure behavior. Future researchers could address this limitation by

employing quasi-experimental designs that exploit the regulation's implementation timing or cross-sectional variation in its applicability. Second, our focus on the unsophisticated investor channel may overlook other important mechanisms through which the BAD provision affects market outcomes. Future studies could examine additional channels, such as the interaction between the BAD provision and other regulatory requirements or its effects on different types of private offerings. Finally, researchers could investigate how the effectiveness of the BAD provision varies with market conditions, investor composition, and firm characteristics, potentially yielding insights for improving regulatory design and implementation.

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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 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	**0.02**	**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.