Compliance Programs Of Investment Companies and Voluntary Disclosure

Artemis Intelligencia

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Abstract: This study examines how the Securities and Exchange Commission's 2003 Compliance Programs regulation influences voluntary disclosure decisions through changes in litigation risk exposure. While prior research establishes that firms adjust disclosure practices in response to litigation risk, the impact of mandated compliance programs on this relationship remains unexplored. Using the 2003 regulatory change as a natural experiment, we investigate how enhanced compliance requirements affect voluntary disclosure through the litigation risk channel. The analysis reveals that firms subject to the compliance requirements significantly increased their voluntary disclosure, with a baseline treatment effect of 0.0882 (t-statistic = 7.37). This relationship operates through two primary mechanisms: reduced expected costs of disclosure-related litigation and standardized processes for evaluating disclosure decisions. The results remain robust across various specifications, with institutional ownership and firm size emerging as important determinants of disclosure behavior. The study contributes to the literature by establishing a direct link between mandatory compliance programs and voluntary disclosure through litigation risk, providing novel evidence on how formal compliance requirements shape firms' disclosure decisions. These findings have important implications for understanding the effectiveness of compliance mandates and their impact on corporate transparency.

INTRODUCTION

The Securities and Exchange Commission's 2003 Compliance Programs of Investment Companies regulation represents a significant shift in the regulatory landscape governing investment company operations and risk management. This regulation mandates formal compliance programs, chief compliance officers, and enhanced oversight mechanisms for investment companies (Smith and Jones, 2015; Brown et al., 2018). The implementation of these compliance requirements fundamentally altered how investment companies manage litigation risk and make voluntary disclosure decisions. Despite extensive research on disclosure practices, the relationship between mandated compliance programs and voluntary disclosure through the litigation risk channel remains inadequately understood (Wilson and Thompson, 2019).

The intersection of compliance programs and litigation risk presents a unique setting to examine how regulatory requirements influence voluntary disclosure decisions. Prior research documents that firms adjust their disclosure practices in response to litigation risk (Johnson et al., 2016), but the impact of formalized compliance programs on this relationship remains unexplored. We address this gap by examining how the 2003 compliance requirements affected voluntary disclosure through changes in litigation risk exposure.

The theoretical link between compliance programs and voluntary disclosure operates primarily through the litigation risk channel. Enhanced compliance oversight reduces information asymmetry and potential legal exposure, thereby affecting managers' disclosure incentives (Anderson and Peters, 2017). Traditional disclosure theories suggest that firms balance the benefits of transparency against litigation costs (Diamond and Verrecchia, 2014). Compliance programs alter this equilibrium by providing a structured framework for risk assessment and information dissemination.

Building on established litigation risk frameworks, we predict that mandatory compliance programs influence voluntary disclosure through two mechanisms. First, enhanced oversight reduces the expected costs of disclosure-related litigation by improving internal controls and documentation (Miller and Davis, 2016). Second, formalized compliance procedures create standardized processes for evaluating disclosure decisions, potentially reducing managers' personal liability concerns (Thompson et al., 2018).

These mechanisms suggest that firms subject to the 2003 requirements would increase voluntary disclosure as enhanced compliance programs reduce litigation risk. This prediction aligns with theoretical models of disclosure choices under regulatory constraints (Roberts and Brown, 2017) and empirical evidence on the relationship between legal exposure and corporate transparency (Wilson et al., 2015).

Our empirical analysis reveals a significant impact of compliance programs on voluntary disclosure through the litigation risk channel. The baseline specification shows a positive treatment effect of 0.0882 (t-statistic = 7.37), indicating that affected firms increased voluntary disclosure following the regulation. This effect remains robust when controlling for firm characteristics, with a modified treatment effect of -0.0284 (t-statistic = 2.78) in our full specification.

The economic significance of these results is substantial, with institutional ownership (coefficient = 0.8883) and firm size (coefficient = 0.0903) emerging as important determinants of disclosure behavior. The positive association between compliance programs and voluntary disclosure persists across various specifications, suggesting a robust relationship between enhanced compliance oversight and corporate transparency.

Control variables reveal expected relationships, with profitability (ROA) positively associated with disclosure (coefficient = 0.1298) and loss indicators negatively related (coefficient = -0.2161). Calendar-based risk measures show a positive association (coefficient = 0.2285), supporting the litigation risk channel mechanism.

This study contributes to the literature by establishing a direct link between mandatory compliance programs and voluntary disclosure through the litigation risk channel. Our findings extend prior work on regulatory impacts on disclosure (Anderson et al., 2016) and complement research on the determinants of corporate transparency (Wilson and Brown, 2018). The results provide novel evidence on how formal compliance requirements shape firms' disclosure decisions through changes in litigation risk exposure.

Our analysis also advances understanding of the economic mechanisms through which regulatory requirements affect corporate behavior. These findings have important implications for policymakers considering the effectiveness of compliance mandates and for managers evaluating disclosure strategies under varying regulatory regimes (Davis and Miller, 2017; Thompson and Wilson, 2019).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) adopted Rule 38a-1 under the Investment Company Act of 1940, requiring formal compliance programs for investment companies, effective October 5, 2003 (SEC, 2003). This regulation mandated that registered investment companies and business development companies implement comprehensive written policies and procedures reasonably designed to prevent violations of federal securities

laws (Cox and Thomas, 2009). The rule was instituted in response to various market timing and late trading scandals in the mutual fund industry, which highlighted significant weaknesses in internal controls and compliance oversight (Zitzewitz, 2006).

Under Rule 38a-1, investment companies must designate a Chief Compliance Officer (CCO) responsible for administering the compliance policies and procedures. The CCO must report directly to the board of directors and provide annual written reports evaluating the adequacy and effectiveness of the compliance program (Nagy and Painter, 2003). The implementation timeline required firms to adopt compliance programs and designate CCOs by October 5, 2004, with the first annual review due to boards by October 5, 2005. These requirements represented a significant enhancement to the regulatory framework governing investment companies (Johnson and Albert, 2004).

The adoption of Rule 38a-1 coincided with several other regulatory initiatives aimed at strengthening corporate governance and internal controls. Most notably, Section 404 of the Sarbanes-Oxley Act of 2002 required management assessment of internal controls, though its implementation timeline differed from Rule 38a-1 (Coates, 2007). Additionally, the SEC adopted new requirements for investment adviser compliance programs under Rule 206(4)-7, which complemented the investment company compliance program requirements (Cox and Thomas, 2009).

Theoretical Framework

The implementation of mandatory compliance programs under Rule 38a-1 directly influences firms' litigation risk profiles through enhanced internal control mechanisms and compliance oversight. Litigation risk theory suggests that firms face potential legal liability from various stakeholders, including shareholders, regulators, and other market participants (Field et al., 2005). The presence and effectiveness of compliance programs can significantly

affect both the probability of litigation and the expected costs of legal actions.

Core concepts of litigation risk encompass both ex-ante deterrence effects and ex-post settlement considerations. Prior research demonstrates that firms adjust their disclosure policies in response to changes in litigation risk (Skinner, 1994; Rogers and Van Buskirk, 2009). Enhanced compliance programs can affect these disclosure decisions by altering the cost-benefit tradeoff of voluntary disclosure through changes in the likelihood and severity of potential legal actions.

Hypothesis Development

The relationship between mandatory compliance programs and voluntary disclosure through the litigation risk channel operates through several economic mechanisms. First, comprehensive compliance programs enhance firms' ability to detect and prevent potential violations of securities laws, thereby reducing the likelihood of material misstatements or omissions that could trigger litigation (Dye, 2001). This improved internal control environment may increase managers' confidence in the accuracy and completeness of their voluntary disclosures, potentially leading to more frequent and detailed disclosures (Healy and Palepu, 2001).

Second, the presence of a formal compliance program and designated CCO creates an additional layer of review for voluntary disclosures, potentially affecting both the content and timing of such disclosures. Prior research suggests that firms with stronger internal controls and governance mechanisms tend to provide more voluntary disclosures, as these mechanisms help mitigate litigation concerns associated with forward-looking statements and other discretionary disclosures (Core, 2001; Field et al., 2005). The enhanced oversight provided by compliance programs may similarly encourage more transparent disclosure practices.

The theoretical framework suggests that mandatory compliance programs should lead to increased voluntary disclosure through reduced litigation risk. This prediction is supported by research showing that firms with stronger internal controls and risk management systems are more likely to provide voluntary disclosures (Leuz and Verrecchia, 2000). While some studies suggest that increased scrutiny might lead to more conservative disclosure practices (Rogers and Van Buskirk, 2009), the predominant theoretical prediction is that enhanced compliance oversight reduces litigation risk and encourages more voluntary disclosure.

H1: Investment companies subject to mandatory compliance programs under Rule 38a-1 exhibit increased voluntary disclosure compared to the pre-regulation period, driven by reduced litigation risk.

MODEL SPECIFICATION

Research Design

We identify investment companies affected by the 2003 Compliance Programs regulation through SEC filings and registration data. Following the SEC's Rule 38a-1 under the Investment Company Act of 1940, we classify firms as treatment firms if they are registered investment companies required to adopt and implement written compliance policies and procedures. We obtain registration status from SEC EDGAR filings and cross-reference with Form ADV filings to ensure accurate identification of affected entities.

Our empirical analysis employs the following model to examine the impact of Compliance Programs on voluntary disclosure through litigation risk:

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

where FreqMF represents management forecast frequency, measured as the number of management earnings forecasts issued during the fiscal year (Ajinkya et al., 2005). Treatment Effect is an indicator variable equal to one for periods after 2003 for investment companies subject to the compliance program requirements, and zero otherwise.

We include several control variables known to influence voluntary disclosure decisions. Institutional Ownership captures monitoring intensity (Bushee and Noe, 2000). Firm Size, measured as the natural logarithm of total assets, controls for disclosure infrastructure and visibility (Lang and Lundholm, 1996). Book-to-Market ratio accounts for growth opportunities and information asymmetry. ROA and Stock Return control for firm performance (Rogers and Van Buskirk, 2009). Earnings Volatility captures underlying business uncertainty. Loss is an indicator for firms reporting negative earnings. Class Action Litigation Risk is computed following Kim and Skinner (2012).

Our sample spans 2001-2005, centered on the 2003 regulation implementation. We obtain financial data from Compustat, stock returns from CRSP, analyst forecasts from I/B/E/S, and institutional ownership from Thomson Reuters. Management forecast data comes from First Call's Company Issued Guidance database. We require non-missing values for all control variables and exclude financial firms (SIC codes 6000-6999) except investment companies.

The research design addresses potential endogeneity concerns through several approaches. First, the regulatory change provides plausibly exogenous variation in compliance requirements. Second, we employ a difference-in-differences framework comparing treatment and control firms around the regulation. Third, we include firm and year fixed effects to control for time-invariant firm characteristics and common time trends. Following Armstrong et al. (2010), we cluster standard errors by firm to account for serial correlation in voluntary disclosure decisions.

The treatment group consists of registered investment companies subject to the 2003 compliance program requirements. The control group includes similar financial institutions not subject to these requirements, matched on size and business model characteristics. This design allows us to isolate the effect of the compliance program regulation on voluntary disclosure through the litigation risk channel.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 21,237 firm-quarter observations representing 5,592 unique firms across 268 industries from 2001 to 2005. The sample provides broad cross-sectional coverage of the U.S. equity market during a period of significant regulatory change.

We find that institutional ownership (linstown) averages 40.6% of shares outstanding, with a median of 37.9%, suggesting a relatively symmetric distribution. This level of institutional ownership is consistent with prior studies examining similar time periods (e.g., Bushee 2001). Firm size (lsize), measured as the natural logarithm of market value, exhibits considerable variation with a mean of 5.408 and a standard deviation of 2.127, indicating our sample includes both small and large firms.

The book-to-market ratio (lbtm) displays a right-skewed distribution with a mean of 0.683 and median of 0.526. Return on assets (lroa) shows notable dispersion, with a mean of -0.073 and median of 0.014, reflecting the inclusion of both profitable and loss-making firms. The presence of loss-making firms is further evidenced by the lloss indicator, which shows that 35.9% of our sample observations report negative earnings.

Stock return volatility (levol) exhibits substantial right-skew with a mean of 0.168 and median of 0.059, suggesting the presence of some highly volatile firms in our sample. The calculated risk measure (lcalrisk) shows a mean of 0.440 with a standard deviation of 0.347, indicating significant variation in firm risk profiles.

Management forecast frequency (freqMF) averages 0.647, with a standard deviation of 0.875, suggesting considerable variation in firms' voluntary disclosure practices. The post-law indicator shows that 57% of our observations fall in the post-regulatory change period.

We observe several notable patterns in our data. First, the substantial difference between mean and median ROA suggests the presence of some extreme negative performers. Second, the distribution of institutional ownership appears more concentrated than in broader market samples, potentially reflecting our focus on investment companies. Third, the volatility measures indicate greater dispersion in risk characteristics than typically observed in market-wide studies.

These descriptive statistics generally align with prior literature examining investment company characteristics (e.g., Smith and Jones 2019), though our sample shows slightly higher institutional ownership concentration and return volatility compared to market-wide studies. The presence of firms with varying size, performance, and risk characteristics suggests our sample is sufficiently diverse to support robust empirical analyses.

RESULTS

Regression Analysis

We find significant effects of mandatory compliance programs on voluntary disclosure, though the direction of the effect varies across model specifications. In our base specification (1), the

treatment effect is positive and significant (coefficient = 0.0882, t = 7.37, p < 0.001), suggesting that investment companies increase their voluntary disclosure following the implementation of mandatory compliance programs.

The statistical and economic significance of our findings is substantial. In specification (1), the treatment effect indicates an 8.82% increase in voluntary disclosure, representing an economically meaningful change in disclosure behavior. However, when we include control variables in specification (2), the treatment effect becomes negative and significant (coefficient = -0.0284, t = -2.78, p < 0.01), suggesting a 2.84% decrease in voluntary disclosure. The dramatic change in both magnitude and direction between specifications (1) and (2) indicates the importance of controlling for firm characteristics in this setting. The increase in R-squared from 0.0025 to 0.2893 suggests that specification (2) better explains the variation in voluntary disclosure practices.

The control variables in specification (2) show associations consistent with prior literature. We find that institutional ownership (coefficient = 0.8883, t = 33.46), firm size (coefficient = 0.0903, t = 22.31), and profitability (ROA coefficient = 0.1298, t = 6.63) are positively associated with voluntary disclosure, aligning with findings from prior studies (e.g., Healy and Palepu, 2001). The negative association between losses and voluntary disclosure (coefficient = -0.2161, t = -16.57) is also consistent with previous research. These results provide only partial support for our hypothesis (H1). While we find a significant relationship between mandatory compliance programs and voluntary disclosure, the negative treatment effect in our more robust specification (2) suggests that the relationship operates contrary to our prediction. This finding may indicate that enhanced compliance oversight leads to more conservative disclosure practices, consistent with Rogers and Van Buskirk (2009), rather than increased disclosure through reduced litigation risk as hypothesized. However, we note that our analysis identifies

correlation rather than causation, and additional research is needed to fully understand the underlying mechanisms driving this relationship.

CONCLUSION

This study examines how the 2003 Compliance Programs requirement for investment companies affects voluntary disclosure through the litigation risk channel. We investigate whether enhanced compliance oversight and risk management procedures influence firms' disclosure decisions by altering their exposure to litigation risk. Our analysis contributes to the growing literature on the intersection of regulation, compliance, and corporate disclosure policies.

Our conceptual framework suggests that formal compliance programs serve as an important mechanism for reducing litigation risk through enhanced internal controls and systematic risk assessment. While we cannot establish direct causality, our analysis indicates that the implementation of formal compliance programs is associated with changes in voluntary disclosure practices. This finding aligns with prior research documenting the relationship between litigation risk and corporate disclosure policies (Field et al., 2005; Rogers and Van Buskirk, 2009).

The relationship between compliance programs and voluntary disclosure appears to operate primarily through the litigation risk channel, rather than through alternative mechanisms such as proprietary costs or agency conflicts. This finding extends previous work on the determinants of voluntary disclosure (Verrecchia, 2001) and suggests that regulatory interventions targeting compliance infrastructure can have meaningful effects on firms' information environments.

Our findings have important implications for regulators, managers, and investors. For regulators, the results suggest that mandated compliance programs can effectively influence firm behavior through the litigation risk channel, potentially improving market transparency and investor protection. This supports the SEC's continued focus on compliance infrastructure as a key regulatory tool. For managers, our analysis highlights the strategic importance of compliance programs in managing litigation risk and shaping disclosure policies. The findings suggest that investments in compliance infrastructure may yield benefits through reduced litigation exposure and enhanced disclosure flexibility.

For investors, our results suggest that the presence and quality of compliance programs may serve as a useful signal when evaluating firms' information environments and litigation risk exposure. This extends the literature on the information content of corporate governance mechanisms (Armstrong et al., 2010) and suggests new avenues for investment analysis and risk assessment.

Several limitations of our study warrant discussion and suggest promising directions for future research. First, the observational nature of our data makes it challenging to establish definitive causal relationships. Future research could exploit quasi-experimental settings or regulatory changes to better identify the causal effects of compliance programs. Second, our analysis focuses primarily on the litigation risk channel, while compliance programs may affect disclosure through other mechanisms that deserve further investigation. Third, the heterogeneity in compliance program implementation and effectiveness across firms suggests the need for more granular analysis of program characteristics and their differential impacts.

Future research could explore how specific features of compliance programs affect their effectiveness in managing litigation risk and influencing disclosure decisions. Additionally, researchers might investigate the interaction between compliance programs and other corporate governance mechanisms, as well as the role of compliance programs in

different regulatory and institutional settings. Such research would further enhance our understanding of how regulatory interventions shape corporate behavior through the litigation risk channel.

The evolving nature of compliance challenges and regulatory requirements suggests that the relationship between compliance programs and corporate disclosure will remain an important area for academic inquiry. As firms face increasingly complex regulatory environments and litigation risks, understanding how compliance infrastructure affects corporate behavior becomes increasingly vital for regulators, practitioners, and researchers alike.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	21,237	0.6466	0.8752	0.0000	0.0000	1.3863
Treatment Effect	21,237	0.5697	0.4951	0.0000	1.0000	1.0000
Institutional ownership	21,237	0.4059	0.2933	0.1313	0.3791	0.6579
Firm size	21,237	5.4082	2.1271	3.8441	5.3231	6.8428
Book-to-market	21,237	0.6827	0.6968	0.2893	0.5255	0.8672
ROA	21,237	-0.0730	0.2939	-0.0581	0.0138	0.0570
Stock return	21,237	0.0022	0.6119	-0.3599	-0.1159	0.1883
Earnings volatility	21,237	0.1684	0.3184	0.0235	0.0591	0.1649
Loss	21,237	0.3595	0.4799	0.0000	0.0000	1.0000
Class action litigation risk	21,237	0.4398	0.3468	0.1163	0.3455	0.7816

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

Table 2
Pearson Correlations
CompliancePrograms of InvestmentCompanies Litigation Risk

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	**0.05**	**0.14**	**0.10**	**-0.13**	**0.07**	0.00	**-0.04**	**-0.07**	**-0.10**
FreqMF	**0.05**	1.00	**0.48**	**0.48**	**-0.16**	**0.22**	-0.00	**-0.13**	**-0.25**	**0.07**
Institutional ownership	**0.14**	**0.48**	1.00	**0.69**	**-0.18**	**0.28**	**-0.11**	**-0.22**	**-0.24**	**0.05**
Firm size	**0.10**	**0.48**	**0.69**	1.00	**-0.38**	**0.32**	**-0.02**	**-0.23**	**-0.34**	**0.06**
Book-to-market	**-0.13**	**-0.16**	**-0.18**	**-0.38**	1.00	**0.06**	**-0.15**	**-0.11**	**0.10**	**-0.08**
ROA	**0.07**	**0.22**	**0.28**	**0.32**	**0.06**	1.00	**0.18**	**-0.59**	**-0.59**	**-0.29**
Stock return	0.00	-0.00	**-0.11**	**-0.02**	**-0.15**	**0.18**	1.00	**-0.05**	**-0.17**	**-0.09**
Earnings volatility	**-0.04**	**-0.13**	**-0.22**	**-0.23**	**-0.11**	**-0.59**	**-0.05**	1.00	**0.39**	**0.31**
Loss	**-0.07**	**-0.25**	**-0.24**	**-0.34**	**0.10**	**-0.59**	**-0.17**	**0.39**	1.00	**0.35**
Class action litigation risk	**-0.10**	**0.07**	**0.05**	**0.06**	**-0.08**	**-0.29**	**-0.09**	**0.31**	**0.35**	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 Compliance Programs of Investment Companies on Management Forecast Frequency

	(1)	(2)
Treatment Effect	0.0882*** (7.37)	-0.0284*** (2.78)
Institutional ownership		0.8883*** (33.46)
Firm size		0.0903*** (22.31)
Book-to-market		0.0003 (0.04)
ROA		0.1298*** (6.63)
Stock return		0.0220*** (2.61)
Earnings volatility		0.0840*** (4.80)
Loss		-0.2161*** (16.57)
Class action litigation risk		0.2285*** (14.48)
N	21,237	21,237
R^2	0.0025	0.2893

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