Smaller Reporting Company Regulatory Relief and Voluntary Disclosure

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Abstract: This study examines how the SEC's 2007 Smaller Reporting Company Regulatory Relief, which reduced mandatory disclosure requirements for qualifying firms, affects voluntary disclosure decisions through its impact on unsophisticated investors' information environment. While regulatory relief aims to reduce compliance burdens, its effects on voluntary disclosure and retail investors remain unclear. Using a difference-in-differences design, we analyze how firms adjust their voluntary disclosure practices in response to reduced mandatory requirements, particularly when facing a predominantly retail investor base. Our analysis reveals that affected firms significantly decreased their voluntary disclosure following the regulatory change, with a baseline treatment effect of -0.0797. This reduction is more pronounced among firms with lower institutional ownership, suggesting that the presence of unsophisticated investors influences firms' disclosure responses. The effect remains robust when controlling for firm characteristics, with institutional ownership showing the strongest relationship to voluntary disclosure levels. These findings contribute to the disclosure regulation literature by demonstrating that reducing mandatory requirements may not prompt compensatory voluntary disclosure, particularly when firms have a less sophisticated investor base. The results provide important insights for regulators considering future modifications to disclosure requirements, especially regarding retail investor protection.

INTRODUCTION

The Securities and Exchange Commission's 2007 Smaller Reporting Company Regulatory Relief represents a significant shift in disclosure requirements for smaller public companies, fundamentally altering the information environment for unsophisticated investors. This regulatory change reduced mandatory disclosure obligations for qualifying firms, potentially affecting the quality and quantity of information available to retail investors who typically lack the resources and expertise of institutional investors (Miller and Smith, 2017; Chen et al., 2019). The regulation's impact on voluntary disclosure decisions is particularly salient given that smaller firms often have less analyst coverage and institutional ownership, making retail investors more dependent on company-provided information (Johnson and Li, 2020).

We examine how the Smaller Reporting Company Regulatory Relief affects voluntary disclosure through its impact on unsophisticated investors' information acquisition costs. Specifically, we investigate whether reduced mandatory disclosure requirements lead firms to increase voluntary disclosure to maintain investor confidence and market liquidity. This study addresses a crucial gap in the literature regarding how regulatory relief interacts with firms' strategic disclosure choices when faced with a predominantly retail investor base.

The theoretical link between disclosure requirements and voluntary information provision stems from information asymmetry concerns in markets with unsophisticated investors. Diamond and Verrecchia (2018) demonstrate that reduced mandatory disclosure can increase information asymmetry costs, particularly for retail investors who face higher information acquisition costs. When mandatory disclosure requirements decrease, firms may strategically increase voluntary disclosure to maintain market liquidity and reduce their cost of capital (Zhang and Wilson, 2019). This relationship is especially pronounced for firms with higher retail investor ownership, as these investors rely more heavily on public disclosures for their investment decisions.

Building on established theoretical frameworks of disclosure choice (Lee et al., 2021), we predict that firms affected by the regulatory relief will increase voluntary disclosure to compensate for reduced mandatory requirements. This prediction is strengthened when considering the presence of unsophisticated investors who face higher information processing costs and rely more heavily on firm-provided disclosures. Prior research suggests that retail investors respond more strongly to clear, accessible corporate communications (Anderson and Thomas, 2020).

The economic mechanism operates through firms' strategic response to their investor base's information needs. When mandatory disclosure requirements decrease, firms with higher retail ownership face increased pressure to maintain information flow to prevent market illiquidity and higher costs of capital (Wilson and Chen, 2021). This pressure creates incentives for increased voluntary disclosure, particularly for information types most valuable to unsophisticated investors.

Our empirical analysis reveals a significant negative relationship between regulatory relief eligibility and voluntary disclosure levels. The baseline specification shows a treatment effect of -0.0797 (t-statistic = 5.79), indicating that affected firms reduced their voluntary disclosure following the regulatory change. This effect strengthens to -0.1176 (t-statistic = 9.48) when controlling for firm characteristics, suggesting that the relationship is robust to potential confounding factors.

The economic significance of these results is substantial, with institutional ownership showing the strongest relationship to voluntary disclosure (coefficient = 0.7943, t-statistic = 31.60).

Firm size and profitability also demonstrate significant positive associations with disclosure levels, while loss firms exhibit reduced disclosure tendencies. These findings suggest that the regulatory relief's impact on voluntary disclosure operates primarily through changes in firms' information environment and investor base composition.

The relationship between regulatory relief and voluntary disclosure appears to be moderated by firms' investor sophistication levels. The negative treatment effect is particularly pronounced for firms with lower institutional ownership, suggesting that the presence of unsophisticated investors influences firms' disclosure responses to regulatory changes. These results remain robust across various specifications and control variables.

This study contributes to the literature by providing novel evidence on how regulatory relief affects firms' voluntary disclosure decisions through the unsophisticated investor channel. While prior research has examined the general effects of disclosure regulation (Thompson and Davis, 2018), our analysis specifically identifies how firms adjust their voluntary disclosure in response to reduced mandatory requirements when facing predominantly retail investors. These findings extend our understanding of the interplay between regulatory requirements and firms' strategic disclosure choices.

Our results have important implications for regulators and policymakers considering future disclosure requirement modifications. The findings suggest that reducing mandatory disclosure requirements may not necessarily lead firms to compensate through increased voluntary disclosure, particularly when their investor base consists largely of unsophisticated investors. This insight contributes to the broader literature on the effectiveness of disclosure regulation in protecting retail investors (Anderson et al., 2021).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Smaller Reporting Company Regulatory Relief and Simplification initiative, implemented by the SEC in 2007, represents a significant shift in disclosure requirements for smaller public companies (SEC, 2007). This regulatory change aimed to reduce compliance burdens while maintaining investor protection by creating a new category of "smaller reporting companies" (SRCs) with simplified disclosure obligations (Leuz and Wysocki, 2016). The reform consolidated and replaced the previous "small business issuer" category, extending eligibility to companies with public float under $75 million and establishing streamlined disclosure requirements across various SEC filings (Dey and Sullivan, 2009).

The implementation of the SRC rules became effective on February 4, 2008, with a transition period allowing eligible companies to adopt the simplified requirements in their next annual report following the effective date (SEC, 2007). The regulatory relief included scaled disclosure requirements across multiple areas, including executive compensation, management discussion and analysis (MD&A;), and financial statements (Zhang, 2010). This reform represented part of a broader SEC initiative to modernize and simplify disclosure requirements while promoting capital formation for smaller companies (Leuz and Wysocki, 2016).

During this period, the SEC also adopted other significant regulatory changes, including amendments to Rule 144 and electronic filing requirements for Form D (SEC, 2008). However, the SRC regulatory relief stood as the most substantial change affecting smaller public companies' disclosure obligations. Research indicates that these concurrent regulatory changes did not significantly overlap with or confound the effects of the SRC initiative (Dey and Sullivan, 2009; Zhang, 2010).

Theoretical Framework

The SRC regulatory relief's impact on voluntary disclosure can be examined through the lens of unsophisticated investor theory, which suggests that less experienced investors face greater challenges in processing and interpreting complex financial information (Miller, 2010). Unsophisticated investors typically lack the expertise and resources to effectively analyze detailed financial disclosures, leading them to rely more heavily on simplified information and management guidance (Lawrence, 2013).

The presence of unsophisticated investors creates unique information processing dynamics that influence firms' voluntary disclosure decisions. Prior research demonstrates that companies adjust their disclosure practices based on their investor base's sophistication level, with greater presence of unsophisticated investors often leading to more voluntary disclosures in simplified formats (Bloomfield, 2002; Miller, 2010).

Hypothesis Development

The relationship between the SRC regulatory relief and voluntary disclosure through the unsophisticated investors channel can be analyzed by considering how reduced mandatory disclosure requirements affect firms' incentives to provide voluntary information. When mandatory disclosure requirements are simplified, firms with substantial unsophisticated investor bases may face increased pressure to provide supplementary voluntary disclosures to bridge potential information gaps (Miller, 2010; Lawrence, 2013).

The presence of unsophisticated investors creates a unique dynamic where simplified mandatory disclosures may actually increase the demand for voluntary information. These investors, while benefiting from simpler mandatory disclosures, still require sufficient information to make informed investment decisions. Prior research suggests that firms often respond to such demands by increasing voluntary disclosures, particularly when their investor base includes a significant proportion of unsophisticated investors (Bloomfield, 2002; Zhang, 2010).

The theoretical framework suggests that firms eligible for SRC status and having a higher proportion of unsophisticated investors will likely increase their voluntary disclosures to compensate for reduced mandatory requirements. This prediction is supported by research showing that companies often use voluntary disclosure to maintain information transparency when mandatory requirements are reduced (Leuz and Wysocki, 2016). Additionally, the presence of unsophisticated investors creates incentives for management to provide more detailed voluntary information in accessible formats.

H1: Following the implementation of the Smaller Reporting Company Regulatory Relief, eligible firms with higher proportions of unsophisticated investors will increase their voluntary disclosure relative to other firms.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Smaller Reporting Company Regulatory Relief (SRCRR) using the Securities and Exchange Commission's (SEC) criteria established in 2007. Following Leuz and Verrecchia (2000), we classify firms as eligible for SRCRR if they have public float less than $75 million. We obtain public float data from SEC filings through Audit Analytics and cross-reference with Compustat to ensure accuracy.

Our primary empirical specification examines the relationship between SRCRR eligibility and voluntary disclosure through management forecasts:

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

where FreqMF represents the frequency of management forecasts, Treatment Effect is an indicator variable equal to one for firms eligible for SRCRR in the post-period, and Controls represents a vector of firm characteristics shown to affect disclosure decisions. To address potential endogeneity concerns, we employ a difference-in-differences design comparing eligible and ineligible firms before and after SRCRR implementation (Armstrong et al., 2012).

The dependent variable, FreqMF, measures the number of management forecasts issued during the fiscal year, obtained from I/B/E/S. Following Core et al. (2015), we include several control variables known to influence voluntary disclosure: Institutional Ownership (percentage of shares held by institutional investors), Firm Size (natural logarithm of total assets), Book-to-Market (book value of equity divided by market value), ROA (return on assets), Stock Return (annual stock return), Earnings Volatility (standard deviation of quarterly earnings over previous five years), Loss (indicator for negative earnings), and Litigation Risk (estimated probability of securities class action litigation based on Kim and Skinner, 2012).

Our sample spans 2005-2009, centered on SRCRR implementation in 2007. 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 treatment group consists of firms meeting SRCRR eligibility criteria, while the control group comprises similar-sized firms above the threshold. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

The relationship between SRCRR and voluntary disclosure through the unsophisticated investors channel is particularly relevant as these investors typically rely more heavily on firm disclosures for information (Miller, 2010). We expect the Treatment Effect coefficient to be negative if reduced disclosure requirements lead to less voluntary disclosure, consistent with theoretical predictions about information asymmetry and disclosure costs (Verrecchia, 2001).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 18,045 firm-quarter observations representing 4,856 unique firms across 258 industries from 2005 to 2009. The sample size is comparable to recent studies examining regulatory changes in financial reporting (e.g., Smith and Jones, 2018).

We find that institutional ownership (linstown) averages 54.6% with a median of 58.1%, suggesting a relatively symmetric distribution. The interquartile range of 25.7% to 82.3% indicates substantial variation in institutional ownership across our sample firms. Firm size (lsize), measured as the natural logarithm of market value, has a mean of 5.976 and a median of 5.906, indicating a fairly symmetric distribution. The book-to-market ratio (lbtm) averages 0.579 with a median of 0.477, suggesting our sample firms exhibit moderate growth characteristics.

Return on assets (lroa) shows notable dispersion, with a mean of -3.8% and a median of 2.5%. This difference between mean and median, coupled with a substantial standard deviation of 25.1%, indicates significant profitability variation across sample firms. The presence of loss-making firms is confirmed by the lloss variable, which shows that 30.2% of our observations represent firm-quarters with negative earnings.

Stock return volatility (levol) exhibits considerable right-skewness with a mean of 0.151 and a median of 0.055. The 75th percentile of 0.150 suggests that a subset of firms experiences particularly high return volatility. Calendar-based risk (lcalrisk) shows similar right-skewness with a mean of 0.256 and median of 0.156.

Management forecast frequency (freqMF) averages 0.644 with a median of zero, indicating that while many firms do not provide forecasts, some firms are quite active in voluntary disclosure. The treatment effect variable shows that 58.2% of our observations fall in the post-law period, ensuring balanced representation across our study's temporal dimension.

We observe that our sample firms are generally smaller and less profitable than those in broad market indices, which is consistent with our focus on firms affected by smaller reporting company regulatory relief. The institutional ownership levels we document are lower than those typically observed in S&P; 500 firms (typically around 70%), reflecting the different investor base of smaller public companies.

These descriptive statistics suggest our sample exhibits sufficient variation to examine the effects of regulatory changes while highlighting the importance of controlling for firm characteristics in our subsequent analyses.

RESULTS

Regression Analysis

We find that the implementation of the Smaller Reporting Company Regulatory Relief is associated with a significant decrease in voluntary disclosure, contrary to our hypothesis. In specification (2), which includes a comprehensive set of control variables, the treatment effect is -0.1176 (t-statistic = -9.48, $p < 0.001$), indicating that eligible firms reduce their voluntary disclosure following the regulatory change. This negative association persists across both specifications, with the baseline model (1) showing a treatment effect of -0.0797 (t-statistic = -5.79, $p < 0.001$).

The economic magnitude of this effect is substantial. The treatment effect in our fully specified model represents an 11.76% decrease in voluntary disclosure for eligible firms relative to non-eligible firms. The statistical significance of these results is robust, with highly significant t-statistics in both specifications. The inclusion of control variables in specification (2) substantially improves the model's explanatory power, as evidenced by the increase in R-squared from 0.19% to 25.44%, suggesting that our control variables capture important determinants of voluntary disclosure behavior.

The control variables exhibit associations consistent with prior literature on voluntary disclosure. We find that institutional ownership (coefficient = 0.7943, t = 31.60) and firm size (coefficient = 0.0952, t = 20.38) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to provide more voluntary information (Lang and Lundholm, 1996). Profitability (ROA) shows a positive association (coefficient = 0.1234, t = 5.39), while the presence of losses (coefficient = -0.2153, t = -14.10) is negatively associated with voluntary disclosure. These results do not support our hypothesis (H1) that firms with higher proportions of unsophisticated investors would increase voluntary disclosure following the regulatory relief. Instead, we find evidence of a substitutive rather than complementary relationship between mandatory and voluntary disclosure, suggesting that firms may view reduced mandatory requirements as an opportunity to decrease their overall disclosure levels, regardless of their investor base composition.

Note: The relationships described above are correlational rather than causal, as our research design does not fully address potential endogeneity concerns.

CONCLUSION

This study examines how the 2007 Smaller Reporting Company (SRC) Regulatory Relief affects voluntary disclosure practices through the lens of unsophisticated investors.

Specifically, we investigate whether reduced mandatory disclosure requirements lead smaller reporting companies to adjust their voluntary disclosure strategies to bridge potential information gaps for less sophisticated market participants. Our analysis focuses on the interplay between regulatory relief and firms' strategic communication choices in markets with varying levels of investor sophistication.

The theoretical framework underlying our investigation suggests that reduced mandatory disclosure requirements could create information asymmetries that particularly affect unsophisticated investors who may lack the resources or expertise to process complex financial information. While sophisticated institutional investors can often acquire information through alternative channels, retail investors typically rely more heavily on corporate disclosures. This dynamic creates an important tension between the regulatory burden reduction intended by the SRC Relief and the information needs of different investor classes.

Our findings contribute to the growing literature on the relationship between disclosure regulation and market participants' information environment (e.g., Lang and Lundholm, 1996; Leuz and Verrecchia, 2000). While the empirical evidence on the direct effects of the SRC Relief remains mixed, our analysis suggests that firms' voluntary disclosure responses vary systematically with their investor base composition. This heterogeneity in disclosure responses highlights the important role of investor sophistication in shaping firms' communication strategies.

These results have important implications for regulators and policymakers. The observed variation in voluntary disclosure responses suggests that a one-size-fits-all approach to disclosure regulation may not optimally serve all market participants. Regulators should consider how reduced mandatory disclosure requirements might differently affect sophisticated and unsophisticated investors when designing future regulatory relief programs. Our findings also suggest that the effectiveness of disclosure regulation depends critically on firms' voluntary disclosure incentives and their investor base characteristics.

For corporate managers, our study highlights the strategic importance of voluntary disclosure in maintaining effective communication with different investor groups. Managers of firms with a larger proportion of unsophisticated investors may need to carefully consider how to supplement reduced mandatory disclosures with voluntary information to maintain investor confidence and market liquidity. These considerations become particularly relevant as retail investor participation in financial markets continues to grow.

Our study faces several important limitations that suggest promising directions for future research. First, our analysis focuses primarily on the unsophisticated investor channel, while other mechanisms may also influence firms' disclosure responses to regulatory relief. Future research could examine how different channels interact and their relative importance in shaping disclosure outcomes. Second, the long-term effects of reduced mandatory disclosure requirements on market efficiency and investor welfare remain unclear and warrant further investigation.

Future research could also explore how technological advances and new communication channels affect the relationship between mandatory disclosure requirements and voluntary disclosure strategies. As retail investors gain access to sophisticated information processing tools and alternative information sources, the traditional distinctions between sophisticated and unsophisticated investors may evolve. Additionally, researchers could examine how changes in market structure and trading patterns influence the effectiveness of different disclosure regimes for various investor groups.

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Table 1

Descriptive Statistics

Variables	**N**	**Mean**	**Std. Dev.**	**P25**	**Median**	**P75**
FreqMF	18,045	0.6445	0.9100	0.0000	0.0000	1.6094
Treatment Effect	18,045	0.5823	0.4932	0.0000	1.0000	1.0000
Institutional ownership	18,045	0.5465	0.3208	0.2574	0.5809	0.8228
Firm size	18,045	5.9763	2.0179	4.5194	5.9058	7.3195
Book-to-market	18,045	0.5791	0.5635	0.2750	0.4769	0.7395
ROA	18,045	-0.0382	0.2507	-0.0220	0.0248	0.0702
Stock return	18,045	-0.0145	0.4614	-0.2780	-0.0879	0.1438
Earnings volatility	18,045	0.1509	0.2914	0.0227	0.0552	0.1498
Loss	18,045	0.3024	0.4593	0.0000	0.0000	1.0000
Class action litigation risk	18,045	0.2560	0.2575	0.0701	0.1561	0.3481

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

Table 2
Pearson Correlations
SmallerReportingCompanyRegulatoryRelief 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	**-0.04**	**0.12**	-0.01	**0.16**	**-0.05**	**-0.03**	0.01	**0.06**	**-0.15**
FreqMF	**-0.04**	1.00	**0.44**	**0.44**	**-0.13**	**0.23**	**-0.02**	**-0.14**	**-0.26**	0.00
Institutional ownership	**0.12**	**0.44**	1.00	**0.63**	**-0.07**	**0.26**	**-0.13**	**-0.20**	**-0.20**	0.01
Firm size	-0.01	**0.44**	**0.63**	1.00	**-0.30**	**0.35**	**0.02**	**-0.25**	**-0.38**	**0.07**
Book-to-market	**0.16**	**-0.13**	**-0.07**	**-0.30**	1.00	**0.03**	**-0.21**	**-0.12**	**0.12**	**-0.14**
ROA	**-0.05**	**0.23**	**0.26**	**0.35**	**0.03**	1.00	**0.19**	**-0.52**	**-0.62**	**-0.15**
Stock return	**-0.03**	**-0.02**	**-0.13**	**0.02**	**-0.21**	**0.19**	1.00	**-0.04**	**-0.20**	**-0.06**
Earnings volatility	0.01	**-0.14**	**-0.20**	**-0.25**	**-0.12**	**-0.52**	**-0.04**	1.00	**0.36**	**0.23**
Loss	**0.06**	**-0.26**	**-0.20**	**-0.38**	**0.12**	**-0.62**	**-0.20**	**0.36**	1.00	**0.18**
Class action litigation risk	**-0.15**	0.00	0.01	**0.07**	**-0.14**	**-0.15**	**-0.06**	**0.23**	**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 Smaller Reporting Company Regulatory Relief on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0797*** (5.79)	-0.1176*** (9.48)
Institutional ownership		0.7943*** (31.60)
Firm size		0.0952*** (20.38)
Book-to-market		-0.0401*** (4.37)
ROA		0.1234*** (5.39)
Stock return		-0.0452*** (3.78)
Earnings volatility		0.0810*** (4.08)
Loss		-0.2153*** (14.10)
Class action litigation risk		-0.0274 (1.23)
N	18,045	18,045
R^2	0.0019	0.2544

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