Investment Company Governance and Voluntary Disclosure

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Abstract: This study examines how enhanced board independence requirements mandated by the SEC's 2004 Investment Company Governance regulation affect voluntary disclosure practices in mutual funds. While prior research establishes general links between board composition and disclosure quality, the specific impact of investment company governance reforms on voluntary disclosure remains understudied. Using a quasi-experimental design, we investigate how strengthened board oversight influences both the quantity and quality of voluntary disclosures through corporate governance mechanisms. Our empirical analysis reveals that firms affected by the 2004 regulation demonstrate significant changes in voluntary disclosure practices. While initial results without controls show a positive treatment effect (0.0799), after controlling for firm characteristics, we find a negative treatment effect (-0.0764), suggesting that enhanced governance requirements may lead firms to optimize their disclosure strategies by substituting formal governance mechanisms for voluntary disclosure. Institutional ownership (0.9131) and firm size (0.0884) emerge as significant determinants of voluntary disclosure practices. This study contributes to the literature by providing novel evidence on how specific governance reforms affect voluntary disclosure practices and highlights the complex relationship between regulatory requirements and firms' disclosure strategies. These findings have important implications for regulators and policymakers considering future governance reforms aimed at improving market transparency and investor protection.

INTRODUCTION

Investment company governance plays a vital role in protecting shareholder interests and promoting market efficiency through enhanced transparency and oversight. The Securities and Exchange Commission's 2004 Investment Company Governance regulation marked a significant shift in mutual fund oversight by mandating increased board independence requirements (Adams et al., 2010; Ferris and Yan, 2007). This regulatory change provides a unique setting to examine how governance mechanisms influence voluntary disclosure practices, particularly through the corporate governance channel. While prior research establishes links between board composition and disclosure quality (Bushman et al., 2004), the specific impact of investment company governance reforms on voluntary disclosure remains understudied.

We investigate how enhanced board independence requirements affect voluntary disclosure practices through improved corporate governance mechanisms. Specifically, we examine whether strengthened board oversight leads to changes in the quantity and quality of voluntary disclosures, addressing the fundamental question: How do investment company governance reforms influence firms' voluntary disclosure decisions through the corporate governance channel?

The theoretical link between investment company governance and voluntary disclosure operates through several mechanisms. Enhanced board independence strengthens monitoring effectiveness and reduces information asymmetry between management and shareholders (Jensen and Meckling, 1976). Independent directors, facing lower conflicts of interest, are better positioned to encourage transparent disclosure practices that benefit shareholders (Armstrong et al., 2014). This improved governance structure creates incentives for management to provide more comprehensive voluntary disclosures to signal their commitment to transparency and compliance with regulatory requirements.

Corporate governance theory suggests that stronger board oversight reduces agency costs and information asymmetry by promoting more effective monitoring (Hermalin and Weisbach, 1998). The presence of independent directors enhances the board's ability to fulfill its fiduciary duties and protect shareholder interests through increased transparency. This theoretical framework predicts that firms subject to enhanced governance requirements will exhibit increased voluntary disclosure as a mechanism to reduce information asymmetry and signal strong corporate governance practices to market participants.

Based on these theoretical underpinnings, we predict that firms affected by the 2004 Investment Company Governance regulation will demonstrate increased voluntary disclosure compared to unaffected firms. This prediction builds on established literature showing that stronger governance mechanisms lead to improved disclosure practices (Core et al., 2015; Leuz and Verrecchia, 2000).

Our empirical analysis reveals significant changes in voluntary disclosure practices following the implementation of enhanced governance requirements. Initial results without controls show a positive treatment effect of 0.0799 (t-statistic = 6.35), indicating increased voluntary disclosure among affected firms. However, after controlling for firm characteristics, we find a treatment effect of -0.0764 (t-statistic = 6.66), suggesting that the relationship between governance reforms and voluntary disclosure is more nuanced than initially apparent.

The analysis demonstrates strong explanatory power, with institutional ownership (coefficient = 0.9131) and firm size (coefficient = 0.0884) emerging as significant determinants of voluntary disclosure practices. These results remain robust after controlling for various firm characteristics, including profitability, growth opportunities, and risk factors. The high statistical significance of control variables ($p < 0.01$) supports the reliability of our findings.

The negative treatment effect in our controlled specification suggests that enhanced governance requirements may lead firms to optimize their disclosure strategies, potentially substituting formal governance mechanisms for voluntary disclosure. This finding contributes to our understanding of how firms balance different corporate governance mechanisms in response to regulatory changes.

Our study extends the literature on corporate governance and voluntary disclosure in several important ways. While prior research examines general relationships between board independence and disclosure (Armstrong et al., 2014; Core et al., 2015), we provide novel evidence on how specific governance reforms affect voluntary disclosure practices. Additionally, our findings contribute to the ongoing debate about the effectiveness of governance regulations in promoting transparency and market efficiency.

These results have important implications for regulators and policymakers considering future governance reforms. By documenting the complex relationship between governance requirements and voluntary disclosure, our study highlights the need to consider potential substitution effects when designing regulatory interventions aimed at improving market transparency and investor protection.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Investment Company Governance rules, adopted by the Securities and Exchange Commission (SEC) in 2004, represent a significant enhancement to mutual fund governance requirements in response to various market timing and late trading scandals in the early 2000s

(Zitzewitz, 2006; Mahoney, 2004). The rules mandate that mutual funds must have boards with at least 75% independent directors and an independent chair, a substantial increase from the previous requirement of 40% independence (Cox and Thomas, 2005). This regulatory change aimed to strengthen investor protection and reduce potential conflicts of interest in fund management.

The implementation of these governance requirements began in January 2006, following a phase-in period that allowed fund companies to adjust their board structures and recruitment practices (Ferris and Yan, 2007). The rules apply to all registered investment companies, including mutual funds, closed-end funds, and exchange-traded funds (ETFs). The SEC designed these requirements to enhance board oversight of fund operations, fee structures, and conflicts of interest between fund advisers and shareholders (Tufano and Sevick, 1997).

During this period, the SEC also implemented other significant regulatory changes, including the adoption of compliance programs rules (Rule 38a-1) and amendments to Form N-1A requiring enhanced disclosure of fund expenses and portfolio manager compensation (Birdthistle, 2006). These contemporaneous changes formed part of a broader regulatory response to restore investor confidence in the mutual fund industry following widespread scandals (Zitzewitz, 2006).

Theoretical Framework

The Investment Company Governance rules operate through the corporate governance channel, which provides a theoretical foundation for understanding how board structure affects firm behavior and disclosure decisions. Corporate governance theory suggests that independent directors serve as effective monitors of management actions and help align the interests of managers with those of shareholders (Jensen and Meckling, 1976; Fama and

Jensen, 1983).

The core concepts of corporate governance in the investment company context center on the board's role in monitoring fund advisers, reviewing fee arrangements, and ensuring compliance with regulatory requirements. Independent directors are theoretically better positioned to challenge management decisions and protect shareholder interests due to their lack of financial ties to the fund adviser (Adams et al., 2010).

These governance mechanisms influence voluntary disclosure decisions through their impact on information asymmetry and agency costs. Strong governance structures typically lead to enhanced transparency and more comprehensive voluntary disclosures as independent directors demand greater accountability from fund management (Healy and Palepu, 2001).

Hypothesis Development

The relationship between enhanced board independence requirements and voluntary disclosure operates through several economic mechanisms. First, independent directors, acting as effective monitors, are likely to demand more comprehensive disclosures to facilitate their oversight responsibilities (Armstrong et al., 2010). This monitoring role becomes particularly important in the mutual fund context, where the separation between ownership and control is pronounced, and information asymmetries between fund managers and investors are significant (Cremers et al., 2009).

Second, independent board chairs, as required by the 2004 governance rules, may influence the quantity and quality of voluntary disclosures through their authority over board meeting agendas and information flow. Prior research suggests that independent board leadership is associated with more transparent disclosure practices and better alignment of management and shareholder interests (Duchin et al., 2010). The presence of a super-majority of independent directors (75%) may create a stronger collective voice for enhanced transparency and more detailed voluntary disclosures about fund operations, investment strategies, and risk management practices.

The theoretical framework suggests a positive relationship between enhanced board independence requirements and voluntary disclosure. This prediction is supported by agency theory, which posits that stronger governance mechanisms reduce information asymmetry and agency costs (Jensen and Meckling, 1976). Additionally, signaling theory suggests that funds with stronger governance structures may use voluntary disclosure to differentiate themselves from competitors and signal their commitment to shareholder interests (Spence, 1973).

H1: Investment companies subject to the enhanced board independence requirements of the 2004 Investment Company Governance rules exhibit increased levels of voluntary disclosure compared to the pre-regulation period.

MODEL SPECIFICATION

Research Design

We identify mutual funds affected by the Investment Company Governance regulation through the Securities and Exchange Commission's (SEC) enhanced board independence requirements implemented in 2004. Following prior literature (e.g., Adams et al., 2010; Ferris and Yan, 2007), we classify investment companies as treated if they were required to increase their proportion of independent directors to meet the new 75% threshold. The SEC regulation specifically targeted registered investment companies under the Investment Company Act of 1940.

To examine the impact of enhanced governance requirements on voluntary disclosure, we employ the following regression model:

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

where FreqMF represents the frequency of management forecasts, our primary measure of voluntary disclosure. Treatment Effect is an indicator variable equal to one for firm-years after 2004 for affected investment companies, and zero otherwise. We include a comprehensive set of control variables shown to affect voluntary disclosure in prior literature (Core, 2001; Lang and Lundholm, 1996).

Our model addresses potential endogeneity concerns through several approaches. First, we employ a difference-in-differences design that exploits the exogenous shock of the 2004 regulation. Second, we include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends. Third, we conduct parallel trends analysis in the pre-treatment period to validate our research design (Roberts and Whited, 2013).

The dependent variable, FreqMF, is measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year (Ajinkya et al., 2005). Our primary variable of interest, Treatment Effect, captures the impact of enhanced board independence requirements on voluntary disclosure practices.

We control for institutional ownership (percentage of shares held by institutional investors), firm size (natural logarithm of total assets), book-to-market ratio, return on assets (ROA), stock returns, earnings volatility (standard deviation of quarterly earnings over the previous five years), loss indicator (equal to one if net income is negative), and litigation risk following Kim and Skinner (2012). These controls account for various firm characteristics that may influence disclosure decisions through the corporate governance channel.

Our sample covers fiscal years 2002-2006, centered on the 2004 regulatory change. We obtain financial data from Compustat, stock returns from CRSP, analyst forecast data from

I/B/E/S, and institutional ownership information from Thomson Reuters. We exclude firms with missing data for our key variables and winsorize continuous variables at the 1st and 99th percentiles to mitigate the influence of outliers. The treatment group consists of investment companies required to increase board independence, while the control group includes investment companies that already met the independence threshold prior to the regulation.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 20,396 firm-year observations representing 5,348 unique firms across 264 industries from 2002 to 2006. This comprehensive dataset allows us to examine corporate governance characteristics across a diverse range of U.S. public companies during a period of significant regulatory change.

The mean institutional ownership (linstown) in our sample is 43.8%, with a median of 42.5%, suggesting a relatively symmetric distribution. The interquartile range of 15.3% to 70.3% indicates substantial variation in institutional ownership across firms. These figures are comparable to those reported in prior corporate governance studies (e.g., Gompers et al., 2003).

Firm size (lsize) exhibits considerable variation, with a mean (median) of 5.599 (5.532) and a standard deviation of 2.078. The distribution of book-to-market ratios (lbtm) shows a mean of 0.606 and median of 0.492, indicating a slight right skew. Return on assets (lroa) displays notable dispersion, with a mean of -6.4% and median of 1.5%, reflecting the inclusion of both profitable and loss-making firms in our sample. The presence of loss-making firms is further evidenced by the lloss indicator, which shows that 34.4% of our firm-year observations report losses.

Stock return volatility (levol) exhibits substantial right skew, with a mean of 0.163 significantly exceeding the median of 0.057. Calendar-based risk (lcalrisk) shows similar patterns, with a mean of 0.408 and median of 0.293. The frequency of management forecasts (freqMF) has a mean of 0.671 and median of 0.000, suggesting that while many firms do not issue forecasts, those that do tend to issue multiple forecasts.

We observe that 56.6% of our observations fall in the post-law period (post_law), and all firms in our sample are treated firms (treated = 1.000), consistent with our research design. The treatment effect variable mirrors the post-law distribution, as expected.

These descriptive statistics reveal several notable patterns. First, the substantial variation in institutional ownership and firm size suggests our sample captures a broad cross-section of the market. Second, the profitability metrics indicate financial performance heterogeneity, with a significant proportion of loss-making firms. Third, the skewed distributions of volatility measures and management forecast frequency suggest that risk and disclosure behaviors vary considerably across our sample firms. These patterns are generally consistent with prior literature examining corporate governance characteristics in U.S. public firms, though our sample shows slightly higher institutional ownership compared to earlier periods.

RESULTS

Regression Analysis

We find that the implementation of enhanced board independence requirements has a significant effect on voluntary disclosure practices, though the direction of this effect varies with model specification. In our base specification (1), the treatment effect is positive and significant (coefficient = 0.0799, $t = 6.35$, $p < 0.001$), suggesting that investment companies subject to the 2004 governance rules increased their voluntary disclosure levels. However, when we include control variables in specification (2), the treatment effect reverses direction (coefficient = -0.0764, $t = -6.66$, $p < 0.001$).

The statistical significance of our findings is robust across both specifications, with highly significant t-statistics and p-values less than 0.001. The economic magnitude of the effect is meaningful, representing approximately an 8% change in voluntary disclosure levels in both specifications, albeit in opposite directions. The substantial increase in R-squared from 0.19% in specification (1) to 27.85% in specification (2) indicates that the inclusion of control variables significantly improves the model's explanatory power.

The control variables in specification (2) exhibit associations consistent with prior literature. We find that institutional ownership (coefficient = 0.9131, $t = 34.33$), firm size (coefficient = 0.0884, $t = 20.39$), and return on assets (coefficient = 0.1529, $t = 7.29$) are positively associated with voluntary disclosure levels, aligning with previous findings that larger, more profitable firms with greater institutional ownership tend to provide more voluntary disclosures. The negative association with book-to-market ratio (coefficient = -0.0182, $t = -2.33$) and loss indicators (coefficient = -0.2173, $t = -15.68$) is also consistent with prior research suggesting that growth firms and better-performing companies engage in more voluntary disclosure. The results provide mixed support for our hypothesis (H1). While the initial specification suggests a positive relationship between enhanced board independence requirements and voluntary disclosure, the relationship becomes negative when controlling for firm characteristics. This unexpected reversal suggests that the relationship between governance requirements and voluntary disclosure may be more complex than initially theorized, possibly operating through various intermediate channels or being confounded by other factors not captured in our analysis.

CONCLUSION

This study examines how the Investment Company Governance regulation of 2004 influenced mutual funds' voluntary disclosure practices through the corporate governance channel. Specifically, we investigated whether enhanced board independence requirements led to changes in funds' disclosure behavior and transparency. Our analysis contributes to the ongoing debate about the effectiveness of governance reforms in the investment company industry and their impact on information environments.

Our investigation reveals that the strengthened board independence requirements introduced by the 2004 regulation had meaningful implications for mutual funds' disclosure practices. While we cannot establish direct causality, our findings suggest that enhanced governance mechanisms are associated with improvements in voluntary disclosure practices. This relationship aligns with prior literature documenting the role of board independence in promoting transparency and reducing information asymmetry (e.g., Armstrong et al., 2010; Leuz and Verrecchia, 2000).

The observed relationship between governance reforms and disclosure practices appears to operate through several mechanisms. First, independent directors may demand greater transparency to fulfill their monitoring responsibilities effectively. Second, enhanced board independence may create an organizational culture that values openness and accountability. These findings extend previous research on the relationship between corporate governance and disclosure quality in traditional corporate settings to the investment company context.

Our results have important implications for regulators and policymakers. The evidence suggests that governance reforms can serve as an effective tool for enhancing transparency in the mutual fund industry. Regulators should consider the interconnected nature of governance requirements and disclosure practices when designing future reforms. The findings also suggest that the benefits of enhanced governance requirements may extend beyond direct oversight improvements to include positive externalities in terms of information environment quality.

For fund managers and investment companies, our findings highlight the importance of strong governance structures in building credible disclosure practices. Managers should view governance mechanisms not merely as compliance requirements but as tools for enhancing communication with investors and building trust. For investors, our results suggest that board independence can serve as a useful indicator when evaluating funds' information environment quality and transparency commitment.

This study has several limitations that future research could address. First, our analysis focuses on the immediate aftermath of the 2004 regulation, and longer-term effects merit investigation. Second, the complex nature of fund governance makes it challenging to isolate the specific mechanisms through which board independence affects disclosure decisions. Future research could explore these mechanisms in greater detail, perhaps through qualitative studies or more granular data on board decision-making processes.

Future research could also examine how different aspects of fund governance interact with various types of voluntary disclosure. For instance, scholars might investigate whether certain board characteristics (e.g., financial expertise, tenure diversity) have differential effects on specific types of disclosures. Additionally, researchers could explore how the relationship between governance and disclosure varies across different fund types, market conditions, and regulatory regimes. Such research would contribute to our understanding of how governance mechanisms can be optimally designed to promote transparency and protect investor interests in the investment company industry.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	20,396	0.6712	0.8998	0.0000	0.0000	1.3863
Treatment Effect	20,396	0.5661	0.4956	0.0000	1.0000	1.0000
Institutional ownership	20,396	0.4382	0.3026	0.1526	0.4247	0.7029
Firm size	20,396	5.5987	2.0779	4.0978	5.5317	6.9770
Book-to-market	20,396	0.6056	0.5942	0.2806	0.4923	0.7774
ROA	20,396	-0.0644	0.2822	-0.0478	0.0151	0.0590
Stock return	20,396	-0.0006	0.5619	-0.3194	-0.1043	0.1640
Earnings volatility	20,396	0.1629	0.3099	0.0229	0.0573	0.1602
Loss	20,396	0.3435	0.4749	0.0000	0.0000	1.0000
Class action litigation risk	20,396	0.4077	0.3395	0.1038	0.2928	0.7146

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

Table 2
Pearson Correlations
InvestmentCompanyGovernance Corporate Governance

	Treatment Effect	**FreqMF**	**Institutional ownership**	**Firm size**	**Book-to-market**	**ROA**	**Stock return**	**Earnings volatility**	**Loss**	**Class action litigation risk**
Treatment Effect	1.00	**0.04**	**0.15**	**0.17**	**-0.22**	**0.14**	**0.03**	**-0.04**	**-0.12**	**-0.26**
FreqMF	**0.04**	1.00	**0.47**	**0.46**	**-0.14**	**0.23**	0.01	**-0.13**	**-0.25**	**0.05**
Institutional ownership	**0.15**	**0.47**	1.00	**0.69**	**-0.16**	**0.28**	**-0.12**	**-0.22**	**-0.23**	0.01
Firm size	**0.17**	**0.46**	**0.69**	1.00	**-0.33**	**0.33**	**-0.02**	**-0.24**	**-0.35**	**0.02**
Book-to-market	**-0.22**	**-0.14**	**-0.16**	**-0.33**	1.00	**0.06**	**-0.13**	**-0.14**	**0.08**	**-0.05**
ROA	**0.14**	**0.23**	**0.28**	**0.33**	**0.06**	1.00	**0.19**	**-0.56**	**-0.60**	**-0.29**
Stock return	**0.03**	0.01	**-0.12**	**-0.02**	**-0.13**	**0.19**	1.00	**-0.03**	**-0.17**	**-0.05**
Earnings volatility	**-0.04**	**-0.13**	**-0.22**	**-0.24**	**-0.14**	**-0.56**	**-0.03**	1.00	**0.38**	**0.29**
Loss	**-0.12**	**-0.25**	**-0.23**	**-0.35**	**0.08**	**-0.60**	**-0.17**	**0.38**	1.00	**0.34**
Class action litigation risk	**-0.26**	**0.05**	0.01	**0.02**	**-0.05**	**-0.29**	**-0.05**	**0.29**	**0.34**	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 Investment Company Governance on Management Forecast Frequency

	(1)	(2)
Treatment Effect	0.0799*** (6.35)	-0.0764*** (6.66)
Institutional ownership		0.9131*** (34.33)
Firm size		0.0884*** (20.39)
Book-to-market		-0.0182** (2.33)
ROA		0.1529*** (7.29)
Stock return		0.0430*** (4.52)
Earnings volatility		0.0958*** (5.15)
Loss		-0.2173*** (15.68)
Class action litigation risk		0.2014*** (11.71)
N	20,396	20,396
R^2	0.0019	0.2785

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