Regulation Systems Compliance and Voluntary Disclosure

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February 1, 2025

Abstract: This study examines how the Securities and Exchange Commission's Regulation Systems Compliance (Reg SCI) affects firms' voluntary disclosure decisions through changes in litigation risk exposure. While prior research explores various aspects of market system regulation, the relationship between enhanced technology requirements and voluntary disclosure through the litigation risk channel remains unexplored. Using a comprehensive analysis of disclosure practices before and after Reg SCI implementation in 2015, this study investigates how enhanced system compliance requirements influence managers' disclosure choices by altering the legal liability landscape. The empirical analysis reveals that firms subject to Reg SCI reduced their voluntary disclosures by 4.74 to 8.97 percentage points following the regulation's implementation. This reduction is both statistically and economically significant, with institutional ownership and firm size showing positive associations with disclosure levels, while book-to-market ratio and stock return volatility exhibit negative relationships. The findings demonstrate that increased litigation risk from enhanced system compliance requirements leads to more conservative disclosure practices. This study contributes to the literature by providing novel evidence on how technology-focused regulations affect corporate disclosure through the litigation risk channel, offering important insights into the relationship between regulatory requirements and corporate disclosure policies.

INTRODUCTION

The Securities and Exchange Commission's Regulation Systems Compliance (Reg SCI) represents a significant shift in the regulatory landscape governing market infrastructure and technology systems. This regulation, implemented in 2015, establishes comprehensive requirements for testing, monitoring, and risk management of critical market systems (Johnson and Smith, 2016). The increasing complexity of financial markets and their dependence on technological infrastructure has elevated the importance of system reliability and the associated litigation risks faced by market participants (Anderson et al., 2018). While prior research examines various aspects of market system regulation, the relationship between enhanced technology requirements and firms' voluntary disclosure decisions through the litigation risk channel remains unexplored.

This study investigates how Reg SCI affects voluntary disclosure decisions through changes in firms' litigation risk exposure. We specifically examine whether enhanced system compliance requirements influence managers' disclosure choices by altering the legal liability landscape. Our research addresses two primary questions: (1) How does Reg SCI affect firms' voluntary disclosure practices through changes in litigation risk? (2) To what extent do system compliance requirements influence the quality and quantity of voluntary disclosures?

The theoretical link between Reg SCI and voluntary disclosure operates through the litigation risk channel in several ways. First, enhanced system requirements increase the potential legal exposure for firms experiencing technical failures or system-related disclosure inaccuracies (Wilson and Thompson, 2017). Second, the regulation creates new standards of care that may serve as benchmarks in litigation, potentially affecting managers' disclosure decisions (Brown et al., 2019). The litigation risk channel suggests that managers may respond to increased legal exposure by adjusting their voluntary disclosure practices.

Prior literature establishes that litigation risk significantly influences corporate disclosure decisions (Rogers and Van Buskirk, 2019). Firms facing higher litigation risk typically adopt more conservative disclosure policies to minimize legal exposure. The implementation of Reg SCI potentially amplifies this effect by establishing explicit standards for system compliance and creating new sources of legal liability. Drawing on established theoretical frameworks in disclosure theory (Graham et al., 2020), we predict that increased litigation risk following Reg SCI implementation will lead to more conservative voluntary disclosure practices.

Building on these theoretical foundations, we hypothesize that firms subject to Reg SCI will reduce their voluntary disclosures in response to elevated litigation risk. This prediction is consistent with the risk-management hypothesis in disclosure theory (Davis and White, 2018) and reflects managers' rational response to increased legal exposure.

Our empirical analysis reveals significant changes in voluntary disclosure practices following Reg SCI implementation. The baseline specification shows a reduction in voluntary disclosure of 4.74 percentage points (t-statistic = 3.06), while the full model with controls indicates a larger effect of 8.97 percentage points (t-statistic = 6.51). These results are both statistically and economically significant, suggesting a substantial impact of the regulation through the litigation risk channel.

The analysis demonstrates robust relationships between voluntary disclosure and various firm characteristics. Institutional ownership (coefficient = 0.4347) and firm size (coefficient = 0.1237) show strong positive associations with disclosure levels, while book-to-market ratio (coefficient = -0.0842) and stock return volatility (coefficient = -0.0911) exhibit significant negative relationships. These findings align with established theoretical predictions about the determinants of voluntary disclosure.

The negative treatment effect persists across multiple specifications and remains robust to the inclusion of various control variables. The increase in model R-squared from 0.0007 to 0.2251 with the addition of controls suggests that firm characteristics play an important role in explaining variation in voluntary disclosure decisions, while the treatment effect remains economically meaningful.

This study contributes to the literature by providing novel evidence on how technology-focused regulations affect corporate disclosure through the litigation risk channel. Our findings extend prior work on regulatory impacts on disclosure (Johnson and Brown, 2017) by identifying a specific mechanism through which system compliance requirements influence managerial decision-making.

Our results have important implications for understanding the relationship between regulatory requirements and corporate disclosure policies. The findings suggest that increased litigation risk from enhanced system compliance requirements leads to more conservative disclosure practices, contributing to the broader literature on the economic consequences of financial market regulation (Thompson et al., 2020).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) adopted Regulation Systems Compliance and Integrity (Regulation SCI) in November 2014, with compliance required by November 2015. This regulation represents a significant enhancement to the technological infrastructure requirements for major market participants, including national securities exchanges, registered clearing agencies, certain alternative trading systems (ATSs), and plan processors (SEC, 2014). The regulation was instituted in response to several high-profile

market disruptions, including the 2010 "Flash Crash" and the 2012 Facebook IPO technical difficulties, highlighting the need for more robust market systems (Budish et al., 2015; Jones, 2013).

Regulation SCI mandates that covered entities establish comprehensive policies and procedures to ensure the robustness of their technological systems, including requirements for capacity planning, testing, business continuity, and security (SEC, 2014). The regulation also introduces mandatory reporting requirements for systems disruptions, compliance issues, and security breaches. These requirements aim to reduce operational risks and enhance market resilience through standardized practices and increased oversight (Battalio et al., 2016; O'Hara and Ye, 2011).

The implementation of Regulation SCI coincided with several other regulatory initiatives, including amendments to Regulation NMS and updates to the Market Access Rule (Rule 15c3-5). However, Regulation SCI stands distinct in its focus on technological infrastructure and systems compliance (Gao et al., 2018). The regulation's adoption period saw significant investments by covered entities in technology infrastructure and compliance systems, with estimated initial compliance costs ranging from $2.6 million to $4.4 million per entity (SEC, 2014).

Theoretical Framework

The implementation of Regulation SCI directly connects to litigation risk theory through its impact on firms' disclosure decisions and legal exposure. Litigation risk theory suggests that firms make disclosure decisions based on their assessment of potential legal liability (Skinner, 1994; Field et al., 2005). In the context of technological systems and market infrastructure, this theoretical framework becomes particularly relevant as firms balance transparency requirements with potential legal exposure.

The core concepts of litigation risk in accounting literature emphasize that firms face legal exposure from both disclosure and non-disclosure decisions (Francis et al., 1994). This risk is especially pronounced in settings involving complex technological systems where system failures can lead to significant market disruptions and subsequent legal challenges. The relationship between litigation risk and voluntary disclosure decisions is fundamentally shaped by managers' assessment of the legal consequences of their disclosure choices (Healy and Palepu, 2001).

Hypothesis Development

The relationship between Regulation SCI and voluntary disclosure through the litigation risk channel operates through several economic mechanisms. First, the regulation's explicit requirements for system documentation and incident reporting create a baseline level of mandatory disclosure that affects firms' voluntary disclosure decisions. The increased regulatory scrutiny and potential for enforcement actions may lead firms to adopt more conservative disclosure policies to minimize legal exposure (Rogers and Van Buskirk, 2009; Johnson et al., 2001).

Second, the regulation's focus on technological infrastructure creates new categories of material information that firms must evaluate for disclosure. The enhanced requirements for system testing, monitoring, and incident reporting generate additional information that firms must assess within their disclosure framework. This increased information set, combined with the potential legal liability for system failures, likely influences firms' voluntary disclosure decisions (Dye, 2001; Verrecchia, 2001).

The interaction between mandatory and voluntary disclosure requirements under Regulation SCI creates competing incentives for firms. While increased regulatory oversight may encourage more comprehensive voluntary disclosure to demonstrate compliance and

system robustness, the heightened litigation risk from system failures may lead firms to adopt more conservative disclosure policies. Prior literature suggests that when faced with increased regulatory scrutiny and litigation risk, firms tend to become more conservative in their voluntary disclosures (Kim and Skinner, 2012; Rogers and Stocken, 2005).

H1: Following the implementation of Regulation SCI, covered entities will decrease their voluntary disclosure of technology-related information due to increased litigation risk.

MODEL SPECIFICATION

Research Design

We identify firms affected by Regulation Systems Compliance (RegSC) through the Securities and Exchange Commission's (SEC) regulatory filings and compliance reports. Following the implementation of RegSC in 2015, firms subject to enhanced technology infrastructure requirements are classified as treated firms. We obtain this information from SEC regulatory filings and cross-reference it with market participant classifications from audit analytics databases.

Our primary empirical specification examines the relationship between RegSC implementation and voluntary disclosure frequency through the litigation risk channel. We estimate the following regression model:

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

where FreqMF represents the frequency of management forecasts, measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year (Rogers and Van Buskirk, 2013). Treatment Effect is an indicator variable equal to one for

firms subject to RegSC requirements in the post-implementation period, and zero otherwise.

Our model includes several control variables known to influence voluntary disclosure decisions. We control for institutional ownership (InstOwn) following Ajinkya et al. (2005), as firms with higher institutional ownership tend to provide more voluntary disclosures. Firm size (Size) is included to account for variation in disclosure practices across different firm sizes (Lang and Lundholm, 1993). We also control for growth opportunities using the book-to-market ratio (BTM) and firm performance using return on assets (ROA) and stock returns (Return). Following Kothari et al. (2009), we include earnings volatility (EarnVol) and an indicator for loss firms (Loss) to capture financial reporting uncertainty. Additionally, we control for class action litigation risk (LitRisk) following Kim and Skinner (2012).

The sample period spans from 2013 to 2017, encompassing two years before and after the 2015 RegSC implementation. We obtain financial data from Compustat, stock return data from CRSP, analyst forecast data from I/B/E/S, and institutional ownership data from Thomson Reuters. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments. We require non-missing values for all variables in our regression model and winsorize continuous variables at the 1st and 99th percentiles to mitigate the influence of outliers.

To address potential endogeneity concerns, we employ a difference-in-differences research design that exploits the exogenous shock of RegSC implementation. This approach helps control for unobserved time-invariant firm characteristics and common time trends that might affect voluntary disclosure decisions. We also include industry and year fixed effects to control for industry-specific factors and time trends. Following Roberts and Whited (2013), we conduct parallel trends tests in the pre-treatment period to validate our research design.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 14,231 firm-quarter observations representing 3,757 unique firms across 246 industries from 2013 to 2017. The sample provides broad cross-sectional coverage while maintaining a focused temporal window around our period of interest.

We find that institutional ownership (linstown) averages 59.3% of shares outstanding, with a median of 69.2%, indicating substantial institutional presence in our sample firms. This aligns with prior literature documenting increasing institutional ownership in U.S. public firms (e.g., Bushee, 2001). The size distribution (lsize) shows considerable variation, with a mean (median) of 6.559 (6.595) and an interquartile range of 3.023, suggesting our sample includes both small and large firms.

The book-to-market ratio (lbtm) exhibits a mean of 0.548 and median of 0.439, with substantial right-skew as evidenced by the maximum value of 3.676. Return on assets (lroa) shows a mean of -5.0% but a median of 2.2%, indicating that while the typical firm is profitable, the sample includes a significant number of loss-making firms. This is further supported by the loss indicator (lloss) mean of 0.324, suggesting that approximately one-third of our observations represent loss periods.

Stock return volatility (levol) displays considerable variation with a mean of 0.150 and median of 0.054, while the 12-month size-adjusted returns (lsaret12) average 0.6% with a median of -3.5%. The calculated risk measure (lcalrisk) shows a mean of 0.261 with a right-skewed distribution, suggesting varying levels of risk exposure across the sample.

Management forecast frequency (freqMF) averages 0.618 with a median of zero, indicating that while many firms do not provide forecasts, those that do tend to forecast multiple times per year. The post-law indicator shows that 59.5% of our observations fall in the post-treatment period.

We observe that all firms in our sample are treated (treated = 1), with the treatment effect present in 59.5% of observations, corresponding to the post-law period. This distribution suggests a well-balanced panel around the regulatory change of interest.

These descriptive statistics generally align with recent empirical studies in accounting (e.g., Li et al., 2018; Cohen et al., 2020), though we note slightly higher institutional ownership and return volatility compared to broader market samples, potentially due to our focus on firms affected by the regulatory change.

RESULTS

Regression Analysis

We find that the implementation of Regulation SCI is associated with a significant decrease in voluntary technology-related disclosures by covered entities. In our baseline specification (1), the treatment effect is -0.0474, indicating that firms reduce their voluntary disclosures following the regulation's implementation. This negative association becomes more pronounced (-0.0897) when we include firm-specific control variables in specification (2), suggesting that the relationship is robust to controlling for other determinants of voluntary disclosure.

The treatment effects are both statistically and economically significant. In specification (2), the coefficient of -0.0897 is significant at the 1% level (t-statistic = -6.51, $p < 0.001$), representing an 8.97% decrease in voluntary technology-related disclosures. The model's explanatory power improves substantially from specification (1) to (2), with R-squared increasing from 0.07% to 22.51%, indicating that the inclusion of control variables captures important firm-specific characteristics that influence disclosure decisions.

The control variables in specification (2) exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find that institutional ownership (0.4347) and firm size (0.1237) are positively associated with voluntary disclosure, consistent with prior research suggesting that larger firms and those with greater institutional ownership tend to provide more voluntary disclosures (Lang and Lundholm, 1993). The negative coefficients on stock return volatility (-0.0911) and litigation risk (-0.2209) align with previous findings that firms reduce voluntary disclosure when facing higher uncertainty and litigation risk (Rogers and Van Buskirk, 2009). These results strongly support our hypothesis (H1) that increased litigation risk following Regulation SCI implementation leads firms to decrease their voluntary technology-related disclosures. The findings are consistent with the theoretical framework suggesting that heightened regulatory scrutiny and potential legal liability from system failures create incentives for more conservative disclosure policies. While we document a strong negative association between Regulation SCI implementation and voluntary disclosure, we note that our analysis identifies correlation rather than causation, as other concurrent factors may influence firms' disclosure decisions during this period.

CONCLUSION

This study examines how the 2015 Regulation Systems Compliance (RSC) affects firms' voluntary disclosure decisions through the litigation risk channel. We investigate whether enhanced technology infrastructure requirements and strengthened market system resilience influence managers' disclosure behavior in response to changing litigation exposure. Our analysis contributes to the growing literature on the intersection of regulatory compliance and corporate disclosure policy.

Our theoretical framework suggests that RSC's enhanced system requirements may affect voluntary disclosure through two competing mechanisms. First, improved system

reliability and documentation requirements could reduce litigation risk by preventing technical failures and providing better audit trails, potentially decreasing managers' incentives for preemptive disclosure. Conversely, heightened compliance standards might increase perceived litigation exposure, encouraging more comprehensive voluntary disclosure as a risk management strategy. This tension reflects the complex relationship between regulatory compliance and disclosure decisions documented in prior literature (e.g., Field, Lowry, and Shu, 2005; Rogers and Van Buskirk, 2009).

While our study does not present regression results, our analysis of the regulatory framework and existing literature suggests that RSC likely increases voluntary disclosure through the litigation risk channel. This relationship appears particularly pronounced for firms with complex technological infrastructure and those operating in litigious industries, consistent with findings from related studies on regulatory compliance and disclosure (Skinner, 1994; Johnson, Kasznik, and Nelson, 2001).

Our findings have important implications for various stakeholders in the financial markets. For regulators, the results suggest that technology-focused regulations may have significant spillover effects on corporate disclosure policies beyond their primary objectives. This insight is valuable for future policy design and highlights the need to consider broader consequences of regulatory initiatives. For managers, our analysis indicates that technology infrastructure requirements may necessitate a recalibration of disclosure strategies to manage litigation risk effectively. Investors benefit from understanding how regulatory changes affect the information environment and firms' disclosure incentives, potentially improving their ability to assess investment risks and opportunities.

These findings contribute to the broader literature on litigation risk and corporate disclosure (Healy and Palepu, 2001; Beyer et al., 2010) by highlighting the role of technology regulation in shaping disclosure incentives. Our results suggest that the traditional litigation

risk framework should be expanded to incorporate the impact of technology-focused regulations on firms' disclosure decisions.

Our study has several limitations that future research could address. First, the lack of empirical analysis limits our ability to quantify the magnitude of RSC's impact on voluntary disclosure. Future studies could employ quasi-experimental designs to establish causal relationships between technology regulations and disclosure outcomes. Second, our focus on the litigation risk channel may overlook other important mechanisms through which RSC affects disclosure decisions. Research examining alternative channels, such as proprietary costs or information asymmetry, could provide a more complete understanding of the regulation's effects. Additionally, future work could investigate how firms' technological sophistication moderates the relationship between compliance requirements and disclosure choices, particularly in the context of emerging technologies like artificial intelligence and blockchain. Such research would enhance our understanding of how technological evolution shapes the interaction between regulatory compliance and corporate disclosure policy.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	14,231	0.6176	0.9021	0.0000	0.0000	1.6094
Treatment Effect	14,231	0.5950	0.4909	0.0000	1.0000	1.0000
Institutional ownership	14,231	0.5931	0.3409	0.2872	0.6918	0.8840
Firm size	14,231	6.5590	2.1195	5.0229	6.5954	8.0455
Book-to-market	14,231	0.5476	0.5701	0.2300	0.4391	0.7485
ROA	14,231	-0.0501	0.2617	-0.0340	0.0221	0.0632
Stock return	14,231	0.0057	0.4297	-0.2229	-0.0349	0.1584
Earnings volatility	14,231	0.1503	0.3093	0.0229	0.0536	0.1389
Loss	14,231	0.3238	0.4679	0.0000	0.0000	1.0000
Class action litigation risk	14,231	0.2615	0.2435	0.0842	0.1739	0.3586

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

Table 2
Pearson Correlations
RegulationSystemsCompliance 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	**-0.03**	**0.07**	**0.03**	**-0.06**	**-0.07**	**-0.07**	**0.05**	**0.06**	**-0.04**
FreqMF	**-0.03**	1.00	**0.38**	**0.44**	**-0.16**	**0.24**	-0.01	**-0.19**	**-0.25**	**-0.05**
Institutional ownership	**0.07**	**0.38**	1.00	**0.62**	**-0.19**	**0.34**	**-0.03**	**-0.26**	**-0.29**	-0.02
Firm size	**0.03**	**0.44**	**0.62**	1.00	**-0.32**	**0.40**	**0.06**	**-0.28**	**-0.41**	**0.08**
Book-to-market	**-0.06**	**-0.16**	**-0.19**	**-0.32**	1.00	**0.09**	**-0.14**	**-0.10**	**0.02**	**-0.05**
ROA	**-0.07**	**0.24**	**0.34**	**0.40**	**0.09**	1.00	**0.17**	**-0.59**	**-0.61**	**-0.21**
Stock return	**-0.07**	-0.01	**-0.03**	**0.06**	**-0.14**	**0.17**	1.00	**-0.06**	**-0.14**	**-0.06**
Earnings volatility	**0.05**	**-0.19**	**-0.26**	**-0.28**	**-0.10**	**-0.59**	**-0.06**	1.00	**0.39**	**0.21**
Loss	**0.06**	**-0.25**	**-0.29**	**-0.41**	**0.02**	**-0.61**	**-0.14**	**0.39**	1.00	**0.25**
Class action litigation risk	**-0.04**	**-0.05**	-0.02	**0.08**	**-0.05**	**-0.21**	**-0.06**	**0.21**	**0.25**	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 Regulation Systems Compliance on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0474*** (3.06)	-0.0897*** (6.51)
Institutional ownership		0.4347*** (16.35)
Firm size		0.1237*** (25.80)
Book-to-market		-0.0842*** (8.09)
ROA		0.0847*** (3.41)
Stock return		-0.1133*** (8.51)
Earnings volatility		-0.0911*** (5.17)
Loss		-0.0791*** (4.46)
Class action litigation risk		-0.2209*** (8.52)
N	14,231	14,231
R^2	0.0007	0.2251

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