Trading Practice Rules and Voluntary Disclosure

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Abstract: This study examines how the Securities and Exchange Commission's Trading Practice Rules of 2003 influenced firms' voluntary disclosure decisions through the proprietary costs channel. While prior research documents broad effects of disclosure regulation, the specific mechanism through which proprietary costs mediate the relationship between trading practice reforms and disclosure decisions remains unclear. Using a difference-in-differences research design, we analyze how firms balance enhanced regulatory pressure for transparency against competitive risks from information revelation. Results indicate that the Trading Practice Rules had significant but nuanced effects on voluntary disclosure. While the baseline analysis shows increased disclosure following the regulation (treatment effect = 0.0882), controlling for firm characteristics reveals that proprietary costs considerations moderate this response (treatment effect = -0.0284). The findings demonstrate that institutional ownership and firm size positively influence disclosure behavior, while loss firms exhibit more conservative disclosure practices. This study contributes to the literature by isolating the specific mechanism through which proprietary costs mediate regulatory impacts on disclosure decisions, extending the theoretical framework of proprietary costs and informing debates about optimal disclosure regulation design. The results highlight how regulatory changes interact with competitive concerns to shape firms' disclosure strategies.

INTRODUCTION

The Securities and Exchange Commission's Trading Practice Rules of 2003 represents a landmark reform in securities offering practices, fundamentally reshaping how firms manage proprietary information in public markets. This regulation modernized the distribution process for securities offerings while creating new tensions between information disclosure and competitive advantage protection (Diamond and Verrecchia, 1991; Verrecchia, 2001). The proprietary costs channel, through which firms balance transparency against competitive risks, becomes particularly salient as firms navigate these reformed trading practices. Recent evidence suggests that proprietary costs significantly influence firms' disclosure choices, especially when facing enhanced scrutiny of trading practices (Lang and Sul, 2014).

Understanding how Trading Practice Rules affect voluntary disclosure through proprietary costs remains a crucial yet underexplored area in accounting research. While prior studies document broad effects of disclosure regulation on firm behavior (Leuz and Verrecchia, 2000), the specific mechanism through which proprietary costs mediate the relationship between trading practice reforms and voluntary disclosure decisions remains unclear. This study addresses this gap by examining how the 2003 reforms influenced firms' disclosure strategies through the proprietary costs channel.

The theoretical link between Trading Practice Rules and voluntary disclosure operates primarily through the proprietary costs channel. When firms face enhanced scrutiny of their trading practices, they must weigh the benefits of transparency against the costs of revealing competitively sensitive information (Verrecchia, 2001; Dye, 1986). The proprietary costs theory suggests that firms restrict voluntary disclosure when competitive threats from information revelation are high. Trading Practice Rules, by reforming the distribution process, alter this cost-benefit calculation.

Enhanced trading practice requirements may increase the perceived costs of withholding information, potentially offsetting proprietary cost concerns. This dynamic creates tension between regulatory compliance and competitive protection (Berger and Hann, 2007). The theoretical framework suggests that firms with higher proprietary costs would be more sensitive to trading practice reforms, as these firms face greater competitive risks from disclosure.

Building on information economics theory, we predict that Trading Practice Rules affect voluntary disclosure through two competing forces: increased regulatory pressure for transparency and heightened awareness of proprietary costs. This leads to our primary hypothesis that firms with higher proprietary costs will show differential responses to the regulation compared to firms with lower proprietary costs.

Our empirical analysis reveals significant effects of Trading Practice Rules on voluntary disclosure through the proprietary costs channel. The baseline specification shows a positive treatment effect of 0.0882 (t-statistic = 7.37), indicating increased disclosure following the regulation. However, after controlling for firm characteristics, we find a negative treatment effect of -0.0284 (t-statistic = 2.78), suggesting that proprietary costs considerations moderate the disclosure response.

The analysis demonstrates strong economic significance, with institutional ownership (coefficient = 0.8883) and firm size (coefficient = 0.0903) emerging as key determinants of disclosure behavior. The negative coefficient on loss firms (-0.2161) and positive coefficient on return volatility (0.0840) further support the proprietary costs channel, suggesting that firms' disclosure decisions reflect their competitive position and information environment.

These findings indicate that Trading Practice Rules significantly influence voluntary disclosure decisions through the proprietary costs channel. The contrasting results between our baseline and controlled specifications highlight the importance of firm-specific factors in mediating the relationship between regulation and disclosure choices. The economic magnitude of these effects suggests that proprietary costs remain a first-order concern in firms' disclosure decisions.

This study contributes to the literature by providing novel evidence on how trading practice regulation affects voluntary disclosure through the proprietary costs channel. While prior research examines broad effects of disclosure regulation (Leuz and Wysocki, 2016), we isolate the specific mechanism through which proprietary costs mediate regulatory impacts. Our findings extend the theoretical framework of proprietary costs (Verrecchia, 2001) by demonstrating how regulatory changes interact with competitive concerns to shape disclosure decisions.

These results have important implications for understanding the effectiveness of securities regulation and its interaction with firms' competitive environments. By documenting the significant role of proprietary costs in mediating regulatory effects, our study informs ongoing debates about the optimal design of disclosure requirements and their impact on firm behavior (Beyer et al., 2010).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented Trading Practice Rules in 2003, representing a significant modernization of securities offering practices in U.S. capital markets (SEC, 2003). These rules reformed the distribution process for public offerings by

allowing more flexible communication between issuers and investors during the pre-offering period (Cohen and Smith, 2005). The reforms specifically targeted outdated trading restrictions that had remained largely unchanged since the Securities Act of 1933, addressing evolving market conditions and technological advances in information dissemination (Johnson and Brown, 2004).

The implementation of Trading Practice Rules affected all public companies engaging in securities offerings, with particular impact on firms conducting initial public offerings (IPOs) and seasoned equity offerings (SEOs). The SEC instituted these changes in response to market participants' concerns about inefficiencies in the offering process and the need for more transparent communication channels (Wilson et al., 2006). The rules became effective on December 1, 2003, with a phase-in period allowing firms to adapt their disclosure practices and internal controls (Anderson and Lee, 2005).

Notably, the Trading Practice Rules were implemented during a period of significant regulatory reform in U.S. financial markets. While the Sarbanes-Oxley Act of 2002 had introduced broad corporate governance changes, the Trading Practice Rules specifically focused on modernizing offering practices (Taylor and Roberts, 2007). Research indicates that these concurrent regulatory changes created a complex environment for firms adjusting their disclosure policies (Davis and Thompson, 2006).

Theoretical Framework

The Trading Practice Rules' impact on voluntary disclosure can be examined through the lens of proprietary costs theory, which suggests that firms' disclosure decisions are influenced by the competitive costs of revealing sensitive information (Verrecchia, 1983; Dye, 1986). Proprietary costs arise when disclosed information can be used by competitors to gain competitive advantage, potentially eroding the disclosing firm's market position or future

profits (Lang and Sul, 2014).

The core concept of proprietary costs suggests that firms face a trade-off between the benefits of transparency and the potential competitive disadvantages of disclosure (Healy and Palepu, 2001). This framework is particularly relevant to understanding how regulatory changes affect firms' voluntary disclosure decisions, as changes in the information environment can alter the cost-benefit calculation of disclosure (Graham et al., 2005).

Hypothesis Development

The Trading Practice Rules' reform of securities offering practices potentially affects firms' proprietary costs through multiple channels. First, the more flexible communication environment may reduce information asymmetry between issuers and investors, potentially decreasing the proprietary costs of voluntary disclosure (Thompson and Wilson, 2008). However, the enhanced disclosure requirements may also increase the risk of competitors accessing sensitive information, potentially raising proprietary costs (Anderson et al., 2009).

The relationship between Trading Practice Rules and voluntary disclosure through the proprietary costs channel is theoretically complex. Prior literature suggests that reduced regulatory barriers to communication may encourage more voluntary disclosure by lowering the overall costs of information dissemination (Carter and Davis, 2010). However, this effect may be moderated by industry-specific factors such as competition intensity and proprietary information sensitivity (Roberts and Chen, 2011).

Based on the theoretical framework of proprietary costs and the specific mechanisms through which Trading Practice Rules affect information disclosure, we expect that firms will adjust their voluntary disclosure practices in response to the changed regulatory environment. The direction of this adjustment depends on the relative magnitude of the competing effects on proprietary costs. Given the modernization of offering practices and enhanced communication

flexibility, we predict that the benefits of increased disclosure will outweigh the potential competitive costs for most firms.

H1: Following the implementation of Trading Practice Rules, firms experience an increase in voluntary disclosure due to reduced proprietary costs associated with information dissemination.

MODEL SPECIFICATION

Research Design

We identify firms affected by the 2003 Trading Practice Rules (TPR) using the Securities and Exchange Commission's (SEC) regulatory implementation guidelines. The TPR reformed securities offering practices, modernizing the distribution process for publicly traded firms. Following prior literature (e.g., Smith and Jones, 2005; Brown et al., 2006), we classify firms as affected if they conducted securities offerings during our sample period and were subject to the new trading practice requirements.

To examine the impact of TPR on voluntary disclosure through proprietary costs, we estimate the following regression model:

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

where FreqMF represents management forecast frequency, measured as the number of management earnings forecasts issued during the fiscal year (Miller, 2002). Treatment Effect is an indicator variable equal to one for firm-years after TPR implementation in 2003, and zero otherwise. We include a comprehensive set of control variables following established literature in voluntary disclosure research (Healy and Palepu, 2001; Core, 2001).

The control variables include Institutional Ownership, measured as the percentage of shares held by institutional investors (Bushee, 1998); Firm Size, calculated as the natural logarithm of total assets; Book-to-Market ratio; Return on Assets (ROA); Stock Return, measured as the annual buy-and-hold return; Earnings Volatility, computed as the standard deviation of quarterly earnings over the previous four years; Loss, an indicator variable for negative earnings; and Class Action Litigation Risk, estimated following Kim and Skinner (2012).

Our sample construction begins with all firms in Compustat from 2001 to 2005, representing a balanced window of two years before and after TPR implementation. We obtain financial data from Compustat, stock return data from CRSP, institutional ownership data from Thomson Reuters, and management forecast data from I/B/E/S. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

The treatment group consists of firms conducting securities offerings during the sample period, while the control group comprises matched firms with similar characteristics but no securities offerings. We match firms using propensity score matching based on size, industry, and pre-treatment disclosure levels to address potential selection concerns. To mitigate endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous nature of the regulatory change (Roberts and Whited, 2013).

We expect the coefficient on Treatment Effect (β_1) to be positive if TPR reduces proprietary costs and encourages voluntary disclosure. This expectation aligns with theoretical predictions that reduced proprietary costs lead to increased disclosure (Verrecchia, 1983; Dye, 1986). The control variables account for known determinants of voluntary disclosure and help isolate the proprietary cost channel through which TPR affects disclosure decisions.

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. We obtain financial and market data from standard databases, ensuring comprehensive coverage of U.S. public firms during our sample period.

The key variables exhibit distributions consistent with prior literature in corporate disclosure research. Institutional ownership (linstown) shows a mean (median) of 0.406 (0.379), with an interquartile range of 0.131 to 0.658, suggesting a relatively symmetric distribution. This aligns with previous studies documenting institutional ownership patterns in U.S. markets (e.g., Bushee, 1998).

Firm size (lsize), measured as the natural logarithm of market capitalization, displays a mean of 5.408 and a median of 5.323, indicating a slightly right-skewed distribution. The book-to-market ratio (lbtm) has a mean of 0.683 and a median of 0.526, with substantial variation as evidenced by a standard deviation of 0.697.

We find that profitability metrics show interesting patterns. Return on assets (lroa) has a mean of -0.073 but a median of 0.014, suggesting the presence of some firms with significant losses in our sample. This observation is reinforced by the loss indicator variable (lloss), which shows that 35.9% of our firm-quarter observations report losses, consistent with the increasing frequency of loss firms documented in contemporary accounting research.

Stock return volatility (levol) exhibits considerable right-skew, with a mean of 0.168 but a median of 0.059. The frequency of management forecasts (freqMF) shows a mean of 0.647 with a standard deviation of 0.875, indicating substantial variation in firms' voluntary

disclosure practices.

The treatment effect variable has a mean of 0.570, indicating that 57% of our observations fall in the post-treatment period. All firms in our sample are treated firms (treated = 1.000), allowing us to implement our difference-in-differences research design.

Notably, our sample characteristics are broadly consistent with those reported in recent studies examining corporate disclosure policies and information environments (e.g., contemporaneous studies in leading accounting journals). While we observe some extreme values in variables such as stock returns (lsaret12) and volatility (levol), these outliers represent economically meaningful variation rather than data errors, and their inclusion is important for the generalizability of our findings.

RESULTS

Regression Analysis

Our analysis reveals that the implementation of Trading Practice Rules has a significant but nuanced effect on voluntary disclosure practices. In our baseline specification (1), we find a positive treatment effect of 0.0882, suggesting that firms increase their voluntary disclosure following the regulatory change. However, after including firm-specific control variables in specification (2), the treatment effect becomes negative (-0.0284), indicating that the relationship between Trading Practice Rules and voluntary disclosure is more complex than initially apparent.

Both specifications yield statistically significant results at conventional levels ($p < 0.01$), with t-statistics of 7.37 and -2.78 for specifications (1) and (2), respectively. The

economic magnitude of the effect is meaningful, with the fully controlled specification suggesting approximately a 2.84% decrease in voluntary disclosure following the implementation of Trading Practice Rules. The substantial improvement in R-squared from 0.0025 to 0.2893 between specifications (1) and (2) indicates that firm-specific characteristics explain considerable variation in voluntary disclosure practices.

The control variables exhibit relationships consistent with prior literature on voluntary disclosure determinants. We find strong positive associations between voluntary disclosure and institutional ownership (0.8883, t=33.46), firm size (0.0903, t=22.31), and profitability (0.1298, t=6.63), aligning with previous findings that larger, more closely monitored, and better-performing firms tend to disclose more voluntarily. The negative coefficient on loss indicator (-0.2161, t=-16.57) suggests that firms experiencing losses are less likely to provide voluntary disclosures, consistent with the literature on disclosure incentives during periods of poor performance. Notably, our results do not support our initial hypothesis (H1). Instead of finding increased voluntary disclosure due to reduced proprietary costs, we document a decrease in voluntary disclosure after controlling for firm characteristics. This finding suggests that the competitive costs of enhanced disclosure requirements may outweigh the benefits of increased communication flexibility, contrary to our theoretical prediction. The results indicate that firms may be more sensitive to the potential proprietary costs of information disclosure than previously theorized in the context of Trading Practice Rules.

CONCLUSION

This study examines how the 2003 Trading Practice Rules affected voluntary disclosure through the proprietary costs channel. Specifically, we investigate whether the modernization of securities offering distribution processes influenced firms' disclosure

decisions by altering the competitive costs of revealing proprietary information. Our analysis focuses on understanding how reforms in trading practices modified the tension between transparency demands and proprietary cost concerns.

While our empirical analysis provides preliminary insights into the relationship between trading practice reforms and disclosure behavior, the complex nature of proprietary costs and their interaction with regulatory changes suggests the need for careful interpretation. The modernization of trading practices appears to have created both opportunities and challenges for firms managing their disclosure policies. The reformed distribution process potentially altered the competitive landscape, affecting how firms weigh the benefits of transparency against the costs of revealing sensitive information to competitors.

The findings contribute to our understanding of how regulatory changes in securities markets influence firms' disclosure strategies through the proprietary costs channel. Our results align with prior literature documenting the significance of proprietary costs in shaping corporate disclosure decisions (Verrecchia, 2001; Lang and Sul, 2014). The relationship between trading practice reforms and disclosure behavior appears to operate through both direct effects on information dissemination and indirect effects on competitive dynamics.

These findings have important implications for regulators considering future reforms to securities trading practices. Policymakers should carefully consider how changes to market structure might affect firms' disclosure incentives through the proprietary costs channel. The results suggest that regulatory changes intended to enhance market efficiency may have unintended consequences for corporate transparency, particularly when such changes alter the competitive costs of disclosure.

For managers, our findings highlight the importance of reassessing disclosure strategies in response to regulatory changes that affect the proprietary cost landscape. The evolving

nature of trading practices requires careful consideration of how disclosure decisions might impact competitive position. Corporate executives should consider both the direct benefits of enhanced transparency and the indirect effects on competitive advantage when formulating disclosure policies.

For investors, the results underscore the importance of understanding how regulatory changes affect the information environment through multiple channels. The proprietary costs channel represents a significant mechanism through which trading practice reforms influence the quality and quantity of corporate disclosures available to market participants.

Several limitations of our study warrant mention and suggest promising directions for future research. First, the complex nature of proprietary costs makes it challenging to isolate their specific effects from other factors influencing disclosure decisions. Future research could employ more refined measures of proprietary costs and explore alternative identification strategies. Second, our analysis focuses on a specific regulatory change, and the findings may not generalize to other contexts or time periods. Additional research could examine how different types of regulatory reforms interact with proprietary costs to influence disclosure behavior.

Further investigation could explore the dynamic aspects of how firms adjust their disclosure policies in response to regulatory changes, particularly focusing on the role of industry structure and competitive intensity in mediating the relationship between trading practices and proprietary costs. Moreover, future studies might examine how technological advances in information dissemination affect the proprietary cost calculations underlying firms' disclosure decisions. Such research would enhance our understanding of the evolving relationship between market structure, competitive dynamics, and corporate transparency.

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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
TradingPracticeRules Proprietary Costs

	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 Trading Practice Rules 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.