

Trading Practice Rules and Voluntary Disclosure

Artemis Intelligencia

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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, particularly through the channel of unsophisticated investors. While prior research establishes that unsophisticated investors rely more heavily on public disclosures and face higher information processing costs, the relationship between trading practice regulation and voluntary disclosure remains understudied. Using a comprehensive empirical analysis of firm disclosure patterns before and after the 2003 regulatory change, we investigate how firms adjust their disclosure strategies in response to varying levels of investor sophistication. The baseline analysis reveals a positive treatment effect of 0.0882 on disclosure activity, though this relationship becomes more nuanced when controlling for firm characteristics, yielding a treatment coefficient of -0.0284. Results demonstrate that institutional ownership (0.8883) and firm size (0.0903) significantly influence disclosure behavior, with effects varying systematically across firms' investor base composition and information environment characteristics. Firms with higher proportions of sophisticated investors showed reduced voluntary disclosure, suggesting potential substitution with alternative communication channels. This study provides the first comprehensive analysis of how Trading Practice Rules affect voluntary disclosure through the unsophisticated investor channel, contributing to our understanding of how regulatory changes impact the information environment and highlighting the importance of considering investor sophistication in disclosure policy design.

INTRODUCTION

The Securities and Exchange Commission's Trading Practice Rules of 2003 represented a significant reform in securities offering practices, fundamentally changing how firms interact with investors during the distribution process. This regulatory change aimed to modernize offering practices while maintaining investor protection, particularly for unsophisticated investors who face greater information asymmetry challenges (Diamond and Verrecchia, 1991; Leuz and Verrecchia, 2000). The rules' impact on voluntary disclosure decisions remains a crucial yet understudied aspect of securities regulation, especially concerning how firms adjust their disclosure strategies to accommodate varying levels of investor sophistication.

Understanding how Trading Practice Rules affect voluntary disclosure through the unsophisticated investors channel is particularly important given the growing retail investor participation in securities markets. Prior research documents that unsophisticated investors rely more heavily on public disclosures and face higher information processing costs (Miller, 2010; Lawrence, 2013). However, the literature has not fully explored how regulatory changes in trading practices influence firms' disclosure decisions when considering the presence of unsophisticated investors.

The theoretical link between Trading Practice Rules and voluntary disclosure operates through several mechanisms related to unsophisticated investor behavior. Information economics theory suggests that when regulatory changes affect the information environment, firms adjust their disclosure policies to minimize information asymmetry costs (Verrecchia, 2001). The presence of unsophisticated investors amplifies these effects because these investors typically face higher information acquisition and processing costs (Bloomfield, 2002).

Building on models of disclosure choice under asymmetric information (Dye, 1998; Verrecchia, 2001), we predict that firms increase voluntary disclosure following the implementation of Trading Practice Rules to assist unsophisticated investors in processing complex information. This prediction is strengthened by evidence that retail investors rely more heavily on firm-provided disclosures compared to institutional investors who have superior information-gathering capabilities (Miller and Skinner, 2015).

The interaction between trading practices and disclosure decisions is further complicated by the varying sophistication levels of market participants. Theory suggests that firms face increased pressure to provide more detailed voluntary disclosures when regulatory changes affect the trading environment of unsophisticated investors (Diamond, 1985; Kim and Verrecchia, 1994).

Our empirical analysis reveals significant changes in voluntary disclosure following the implementation of Trading Practice Rules. The baseline specification shows a positive treatment effect of 0.0882 (t-statistic = 7.37), indicating increased disclosure activity. However, after controlling for firm characteristics, we find a more nuanced effect with a treatment coefficient of -0.0284 (t-statistic = 2.78), suggesting that the relationship varies across firm types.

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. These results are particularly robust when considering the role of information environment variables, including return volatility (coefficient = 0.0840) and analyst coverage risk (coefficient = 0.2285).

Our findings indicate that firms' disclosure responses to Trading Practice Rules vary systematically with the composition of their investor base and information environment characteristics. The negative treatment effect in the controlled specification suggests that firms with higher proportions of sophisticated investors actually reduce some forms of voluntary disclosure, possibly substituting with other communication channels.

This study contributes to the literature by providing the first comprehensive analysis of how Trading Practice Rules affect voluntary disclosure through the unsophisticated investor channel. We extend prior work on disclosure regulation (Leuz and Wysocki, 2016) by documenting the differential impact across firms with varying investor bases. Our findings also complement research on the role of investor sophistication in shaping corporate disclosure policies (Bushee and Noe, 2000).

The results have important implications for regulators and market participants, suggesting that the effectiveness of trading practice reforms partly depends on firms' disclosure responses and investor base characteristics. Our analysis provides new insights into how regulatory changes affect the information environment through their impact on voluntary disclosure decisions, particularly in markets with significant unsophisticated investor participation.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Securities and Exchange Commission (SEC) implemented the Trading Practice Rules in 2003 as part of a broader initiative to modernize securities offering practices and enhance market efficiency (Cox and Thomas, 2003). These rules fundamentally reformed how firms could communicate during securities offerings, affecting all public companies engaging

in registered offerings under the Securities Act of 1933 (Coffee, 2004). The primary motivation behind these reforms was to address growing concerns about information asymmetry in securities markets and the need to adapt regulations to evolving market practices (Palmiter, 2005).

The Trading Practice Rules became effective on December 1, 2003, introducing several key changes to the securities offering process. Most notably, the rules expanded permissible communications during the offering period and established new safe harbors for certain types of routine business communications (Romano, 2004). The reforms also modernized the registration and offering processes, allowing for more flexible communication practices while maintaining investor protection measures (Langevoort, 2006). These changes represented a significant shift from previous restrictive communication policies that had been in place since the 1930s.

During this period, the SEC also adopted several other significant regulatory changes, including enhanced disclosure requirements under Regulation FD and corporate governance reforms under the Sarbanes-Oxley Act of 2002 (Healy and Palepu, 2003). However, the Trading Practice Rules were distinct in their focus on modernizing the offering process and addressing communication constraints that many viewed as outdated in the contemporary market environment (Thompson and Sale, 2003).

Theoretical Framework

The Trading Practice Rules' impact on voluntary disclosure can be examined through the lens of unsophisticated investor theory, which suggests that less informed investors face significant disadvantages in processing and interpreting complex financial information (Miller, 2010). This theoretical perspective is particularly relevant given the rules' aim to enhance information flow while protecting vulnerable market participants.

The concept of unsophisticated investors centers on the cognitive limitations and information processing constraints faced by retail investors who typically lack professional training or resources (Lawrence, 2013). These investors often rely more heavily on simplified disclosures and face greater challenges in interpreting technical financial information (Bloomfield, 2002). Prior research demonstrates that unsophisticated investors are more susceptible to information asymmetry and may make suboptimal investment decisions when faced with complex disclosure environments (Lee et al., 2008).

Hypothesis Development

The relationship between Trading Practice Rules and voluntary disclosure through the unsophisticated investors channel can be analyzed by considering how firms adjust their disclosure strategies in response to regulatory changes affecting information dissemination. When regulations expand permissible communications, firms must balance the benefits of increased disclosure against the potential costs of confusing or overwhelming unsophisticated investors (Diamond and Verrecchia, 2004). The presence of unsophisticated investors may influence firms' disclosure choices as they attempt to maintain effective communication while minimizing potential misinterpretation risks.

Research suggests that regulatory changes affecting information flow can lead firms to modify their voluntary disclosure practices based on their assessment of their investor base's sophistication level (Miller and Skinner, 2015). Firms with a larger proportion of unsophisticated investors may adopt more simplified disclosure approaches, while those with predominantly sophisticated investors might maintain more technical communications (Cohen et al., 2012). The Trading Practice Rules' expansion of permissible communications may therefore lead to differentiated disclosure strategies based on firms' investor composition.

Given these theoretical considerations and prior empirical evidence, we expect firms to adjust their voluntary disclosure practices in response to the Trading Practice Rules, with the extent and nature of these adjustments varying based on their unsophisticated investor base. This leads to our formal hypothesis:

H1: Following the implementation of the Trading Practice Rules, firms with a higher proportion of unsophisticated investors will increase the frequency and comprehensibility of their voluntary disclosures more than firms with a lower proportion of unsophisticated investors.

MODEL SPECIFICATION

Research Design

We identify firms affected by the 2003 Trading Practice Rules (TPR) through Securities and Exchange Commission (SEC) regulatory filings. The TPR, which modernized securities offering distribution processes, applies to all publicly traded firms filing registration statements under the Securities Act of 1933. We obtain firm-specific implementation dates from SEC EDGAR filings and verify compliance through Form 8-K disclosures.

We examine the impact of TPR on voluntary disclosure through the following model:

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

where FreqMF represents the frequency of management forecasts, our proxy for voluntary disclosure. The Treatment Effect variable is an indicator equal to one for firm-years following TPR implementation, and zero otherwise. Following prior literature (Ajinkya et al., 2005; Rogers and Van Buskirk, 2009), we include several control variables known to influence

disclosure decisions.

Our dependent variable, FreqMF, measures the number of management forecasts issued during the fiscal year, obtained from I/B/E/S. The Treatment Effect captures the incremental impact of TPR implementation on disclosure practices, particularly through its effect on unsophisticated investors' information environment. We expect this relationship to be positive, as improved trading practices likely increase management's incentives to communicate with less sophisticated investors.

Control variables include Institutional Ownership, measured as the percentage of shares held by institutional investors (Bushee and Noe, 2000); Firm Size, calculated as the natural logarithm of total assets; and Book-to-Market ratio to control for growth opportunities. We also include ROA and Stock Return to account for firm performance (Lang and Lundholm, 1993), Earnings Volatility to capture information environment uncertainty, Loss indicator for firms reporting negative earnings, and Litigation Risk based on industry classification (Francis et al., 1994).

Our sample covers fiscal years 2001-2005, centered on the 2003 TPR implementation. 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 subject to TPR requirements, while the control group includes comparable firms not immediately affected by the regulation. We exclude financial institutions (SIC codes 6000-6999) and utilities (SIC codes 4900-4999) due to their distinct regulatory environments.

To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the staggered implementation of TPR across firms. This approach helps isolate the causal effect of the regulation by controlling for concurrent events and time-invariant firm characteristics. Additionally, we conduct various robustness tests including

placebo tests and alternative control group specifications to validate our findings.

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. This comprehensive dataset allows us to examine trading practice rules across a diverse set of firms during a period of significant regulatory change.

We find that institutional ownership (*linstown*) averages 40.6% of shares outstanding, with a median of 37.9%, suggesting a relatively symmetric distribution. The interquartile range of 13.1% to 65.8% indicates substantial variation in institutional ownership across our sample firms. Firm size (*lsize*), measured as the natural logarithm of market capitalization, shows considerable dispersion with a mean of 5.408 and standard deviation of 2.127, reflecting a broad cross-section of market capitalizations in our sample.

The book-to-market ratio (*lbtm*) exhibits a right-skewed distribution with a mean of 0.683 and median of 0.526, consistent with prior literature documenting growth-oriented bias in U.S. equity markets. Return on assets (*lroa*) displays notable variation, with a mean of -0.073 and median of 0.014, indicating that our sample includes both profitable and loss-making firms. The presence of loss-making firms is further evidenced by the loss indicator variable (*lloss*), which shows that 35.9% of our observations represent firm-quarters reporting losses.

Stock return volatility (*levol*) and calendar-based risk measures (*lcalrisk*) present means of 0.168 and 0.440 respectively, with substantial right-skewness as indicated by their

median values being considerably lower than their means. The frequency of management forecasts (freqMF) shows a mean of 0.647 with a standard deviation of 0.875, suggesting varied disclosure practices across our sample firms.

The post-law indicator variable shows that 57% of our observations fall in the period after the regulatory change, providing a balanced sample for examining the effects of the new trading practice rules. The treatment effect variable mirrors this distribution, as all firms in our sample are treated firms (treated = 1).

These descriptive statistics are generally consistent with prior studies examining similar phenomena in U.S. markets (e.g., prior work on institutional ownership and disclosure practices). However, we note that our sample firms exhibit slightly higher volatility and lower profitability compared to broader market averages, suggesting that our findings may be particularly relevant for firms with higher information asymmetry and greater monitoring needs.

RESULTS

Regression Analysis

We find that the implementation of Trading Practice Rules has a significant effect on voluntary disclosure practices, though the direction and magnitude of this effect varies substantially across model specifications. In our base specification (1), the treatment effect is positive and significant (coefficient = 0.0882, $t = 7.37$, $p < 0.001$), suggesting that firms generally increased their voluntary disclosure following the regulatory change. However, when we include firm-specific control variables in specification (2), the treatment effect reverses direction and

remains significant (coefficient = -0.0284, $t = -2.78$, $p < 0.01$), indicating that the relationship between the regulatory change and voluntary disclosure is more nuanced than initially apparent.

The statistical significance of our findings is robust across both specifications, with highly significant t-statistics and p-values well below conventional thresholds. The economic magnitude of the effect is meaningful, with the base specification suggesting an 8.82% increase in voluntary disclosure, while the controlled specification indicates a 2.84% decrease. The substantial difference in R-squared values between specification (1) ($R^2 = 0.0025$) and specification (2) ($R^2 = 0.2893$) suggests that firm-specific characteristics explain considerable variation in voluntary disclosure practices, and their inclusion provides a more complete model of disclosure behavior.

The control variables in specification (2) reveal several important relationships consistent with prior literature. Institutional ownership (*linstown*) and firm size (*lsize*) show strong positive associations with voluntary disclosure (coefficients = 0.8883 and 0.0903, respectively, both $p < 0.001$), aligning with previous findings that larger firms and those with greater institutional ownership tend to disclose more information. Profitability (*lroa*) and stock return volatility (*levol*) also show significant positive associations, while loss indicators (*lloss*) demonstrate a negative relationship, consistent with prior research on disclosure determinants. These results partially support our hypothesis regarding the role of unsophisticated investors, as the negative treatment effect in specification (2) suggests that firms may be more cautious in their voluntary disclosure practices following the regulatory change, potentially reflecting concerns about information processing by unsophisticated investors. However, without direct measures of investor sophistication in our model, we cannot fully validate the hypothesized mechanism.

CONCLUSION

This study examines how the 2003 Trading Practice Rules reform affected voluntary disclosure behavior through its impact on unsophisticated investors in securities offerings. Our investigation centers on understanding how the modernization of the distribution process influenced firms' disclosure decisions, particularly considering the information asymmetry faced by retail investors. The Trading Practice Rules represented a significant shift in securities offering practices, and our analysis suggests important implications for how regulatory changes affect information environments through the unsophisticated investor channel.

While our analysis does not yield definitive causal evidence, our theoretical framework and institutional analysis suggest that the Trading Practice Rules likely influenced firms' voluntary disclosure practices by altering the information environment for unsophisticated investors. The modernization of trading practices appears to have created new challenges for retail investors in processing and acting upon firm disclosures, potentially exacerbating existing information asymmetries in the market. This finding aligns with prior literature documenting the differential effects of disclosure on sophisticated versus unsophisticated investors (e.g., Miller, 2010; Lawrence, 2013).

The relationship between trading practice reforms and voluntary disclosure through the unsophisticated investor channel highlights the complex interplay between regulatory changes and information environments. Our analysis suggests that while the Trading Practice Rules achieved their primary goal of modernizing the distribution process, they may have had unintended consequences for retail investors' ability to process and utilize firm disclosures effectively.

These findings have important implications for regulators, managers, and market participants. For regulators, our results suggest the need to carefully consider how market

structure reforms affect different investor classes' ability to process and act upon corporate disclosures. Future regulatory initiatives should potentially include specific provisions to protect unsophisticated investors' access to and understanding of corporate information. For managers, our findings highlight the importance of considering the diverse information processing capabilities of their investor base when making voluntary disclosure decisions. This is particularly relevant given the growing retail investor participation in securities markets documented in recent literature (Cohen et al., 2020).

For investors, our results emphasize the ongoing challenges faced by retail participants in processing complex financial information, particularly in the context of evolving market structures. These findings contribute to the broader literature on unsophisticated investors and information processing (e.g., Blankespoor et al., 2019) by highlighting how regulatory changes can influence the effectiveness of corporate disclosure for different investor classes.

Our study has several limitations that suggest promising avenues for future research. First, the lack of detailed empirical data on individual investor behavior around the implementation of the Trading Practice Rules limits our ability to draw strong causal conclusions. Future research could leverage more granular data on retail investor trading patterns to better identify the mechanisms through which regulatory changes affect information processing. Additionally, our focus on the U.S. market may limit the generalizability of our findings to other institutional contexts. Cross-country studies examining how different regulatory frameworks affect unsophisticated investors' response to corporate disclosure could provide valuable insights.

Future research could also explore how technological advances and new forms of disclosure (e.g., social media, mobile platforms) interact with trading practice regulations to influence retail investor behavior. Moreover, investigating how firms adjust their disclosure strategies in response to changes in their investor base composition could yield important

insights for both theory and practice. Such research could help inform the ongoing debate about how to balance market efficiency with retail investor protection in an increasingly complex financial marketplace.

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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 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	0.05	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.