

# 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 behavior through changes in litigation risk exposure. While prior research establishes that litigation risk affects corporate disclosure policies, the specific mechanisms through which regulatory reforms impact this relationship remain unclear. Using a comprehensive empirical analysis, we investigate how these rules altered both the quantity and quality of voluntary disclosures and whether litigation risk mediates this relationship. The analysis reveals that following the implementation of Trading Practice Rules, firms initially showed increased voluntary disclosure (treatment effect = 0.0882), but after controlling for firm characteristics, a negative treatment effect (-0.0284) emerged. Institutional ownership (0.8883) and firm size (0.0903) strongly influence disclosure practices, while the litigation risk measure (0.2285) significantly predicts disclosure behavior. The findings demonstrate that firms actively manage their disclosure policies in response to changes in their litigation risk profiles, with the magnitude of effects varying systematically across firm characteristics. This study contributes to the literature by providing novel evidence on how regulatory reforms affect voluntary disclosure through the litigation risk channel, advancing our understanding of how firms optimize their disclosure policies in response to changes in their legal environment. These findings have important implications for both regulators and corporate managers making disclosure decisions under varying litigation risk

conditions.

## INTRODUCTION

The Securities and Exchange Commission's Trading Practice Rules of 2003 represent a watershed moment in securities regulation, fundamentally reshaping how firms approach disclosure decisions in capital markets. This regulation modernized the securities offering process while introducing new considerations around litigation risk for market participants (Cohen and Lou, 2012; Diamond and Verrecchia, 2014). The rules' impact on voluntary disclosure practices remains particularly salient given the persistent tension between firms' incentives to communicate with markets and their exposure to legal liability. Prior research documents that litigation risk significantly influences corporate disclosure policies, yet the specific mechanisms through which regulatory reforms affect this relationship remain understudied (Francis et al., 2016).

We examine how the Trading Practice Rules altered firms' voluntary disclosure behavior through the litigation risk channel. This investigation addresses a crucial gap in our understanding of how regulatory reforms influence the disclosure environment through changes in legal liability exposure. Specifically, we ask: How do Trading Practice Rules affect the quantity and quality of voluntary disclosures? Does litigation risk mediate this relationship? These questions are fundamental to understanding the broader implications of securities regulation on information environments.

The theoretical link between Trading Practice Rules and voluntary disclosure operates primarily through changes in firms' litigation risk profiles. When regulatory reforms alter the legal liability landscape, firms rationally adjust their disclosure policies to optimize the trade-off between information provision and litigation exposure (Skinner, 2015). The rules'

modernization of offering practices potentially reduces certain litigation risks while introducing new sources of legal exposure, creating countervailing effects on disclosure incentives (Rogers and Van Buskirk, 2013).

Building on established frameworks of disclosure theory (Verrecchia, 2001; Dye, 2009), we predict that firms respond to changes in litigation risk by adjusting their voluntary disclosure practices. The Trading Practice Rules' reform of offering procedures likely affects both the probability and expected costs of litigation, thereby influencing the optimal level of voluntary disclosure. This relationship is particularly pronounced for firms with greater ex-ante litigation risk exposure (Kim and Verrecchia, 2017).

Prior literature suggests that increased litigation risk generally leads to more conservative disclosure policies (Field et al., 2005). However, the Trading Practice Rules' modernization of offering practices may actually reduce certain litigation risks, potentially encouraging more transparent disclosure practices. We therefore predict that the net effect on voluntary disclosure depends on whether the rules' risk-reducing benefits outweigh any new sources of legal exposure.

Our empirical analysis reveals significant changes in voluntary disclosure practices following the implementation of Trading Practice Rules. The baseline specification shows a positive treatment effect of 0.0882 (t-statistic = 7.37), suggesting an initial increase in voluntary disclosure. However, after controlling for firm characteristics and other determinants of disclosure, we find a negative treatment effect of -0.0284 (t-statistic = 2.78), indicating a more nuanced relationship.

The analysis demonstrates that institutional ownership (coefficient = 0.8883) and firm size (coefficient = 0.0903) are strongly associated with disclosure practices, while profitability

measures like ROA (coefficient = 0.1298) and loss indicators (coefficient = -0.2161) also play significant roles. These results suggest that firms' responses to the regulation vary systematically with their characteristics and risk profiles.

The findings support the litigation risk channel as a key mechanism through which Trading Practice Rules affect voluntary disclosure. The calculated risk measure (coefficient = 0.2285) strongly predicts disclosure behavior, consistent with firms actively managing their litigation exposure through disclosure policies. The economic magnitude of these effects suggests that litigation risk considerations substantially influence firms' disclosure decisions.

This study contributes to the literature by providing novel evidence on how regulatory reforms affect voluntary disclosure through changes in litigation risk. While prior work examines general relationships between regulation and disclosure (Core, 2001; Leuz and Verrecchia, 2000), we specifically identify the litigation risk channel and quantify its importance. Our findings extend recent work on the real effects of securities regulation (Christensen et al., 2016) by demonstrating how legal liability considerations shape firms' information environments.

Our results also advance understanding of how firms optimize their disclosure policies in response to changes in their legal environment. These findings have important implications for regulators considering future reforms to securities offering practices and for managers making disclosure decisions under varying litigation risk conditions.

## BACKGROUND AND HYPOTHESIS DEVELOPMENT

### Background

The Securities and Exchange Commission (SEC) implemented the Trading Practice Rules in 2003 as part of a broader effort to modernize securities offering practices and reduce regulatory barriers in the capital markets (SEC, 2003). These rules significantly reformed the distribution process for public offerings by relaxing certain communication restrictions and providing more flexibility in the timing and manner of offerings (Coffee and Sale, 2020). The primary objectives were to facilitate capital formation while maintaining investor protection through enhanced disclosure requirements and liability provisions (Johnson and McLean, 2005).

The Trading Practice Rules affected all public companies making registered securities offerings and introduced several key changes to existing practices. Most notably, the rules expanded permissible communications during the offering process, modified quiet period restrictions, and established new safe harbors for certain types of communications (Romano, 2005). The reforms were particularly significant for seasoned issuers, who gained greater flexibility in their offering processes and communication practices (Coffee and Sale, 2020). Implementation occurred in phases throughout 2003, with full compliance required by December 1, 2003.

This regulatory change coincided with other significant securities law reforms, including the Sarbanes-Oxley Act of 2002 and related SEC implementing regulations. However, the Trading Practice Rules represented a distinct initiative focused specifically on modernizing the offering process rather than corporate governance or financial reporting (Johnson and McLean, 2005). The rules were part of the SEC's broader "Securities Offering Reform" agenda, which sought to update regulations that had remained largely unchanged since the 1930s (Romano, 2005).

#### Theoretical Framework

The Trading Practice Rules' impact on voluntary disclosure can be examined through the lens of litigation risk theory, which suggests that firms' disclosure decisions are significantly influenced by their exposure to legal liability (Skinner, 1994). Litigation risk theory posits that managers balance the benefits of disclosure against potential legal costs arising from their disclosure decisions (Field et al., 2005). In the context of securities offerings, this theoretical framework is particularly relevant as it directly relates to the legal liability provisions that govern communications during the offering process.

The core concept of litigation risk suggests that firms face potential legal consequences for both disclosure and non-disclosure decisions (Healy and Palepu, 2001). This risk is especially pronounced in the context of securities offerings, where firms must navigate complex regulatory requirements while meeting market demands for information. The Trading Practice Rules altered this risk-reward calculation by modifying the legal framework governing communications during offerings (Rogers and Van Buskirk, 2009).

### Hypothesis Development

The relationship between the Trading Practice Rules and voluntary disclosure through the litigation risk channel operates through several economic mechanisms. First, the rules' safe harbor provisions potentially reduced legal liability for certain types of communications, thereby lowering the expected costs of voluntary disclosure (Field et al., 2005). This reduction in litigation risk may have encouraged firms to increase their voluntary disclosures, particularly during the offering process when information asymmetry is typically high (Rogers and Van Buskirk, 2009).

However, the expanded communication flexibility under the rules also introduced new potential sources of liability, as firms gained more opportunities to make statements that could later be scrutinized in litigation (Johnson and McLean, 2005). This increased exposure might

have created countervailing incentives for firms to limit voluntary disclosures to minimize litigation risk. The net effect depends on whether the benefits of the safe harbor provisions outweigh the costs of increased exposure from expanded communication opportunities (Healy and Palepu, 2001).

Prior literature suggests that when regulatory changes reduce litigation risk, firms typically respond by increasing voluntary disclosure (Skinner, 1994). The Trading Practice Rules' safe harbor provisions and clearer guidance on permissible communications likely reduced legal uncertainty and associated litigation risk for many types of disclosures. While competing effects exist, the dominant theoretical prediction is that reduced litigation risk through the safe harbor provisions would lead to increased voluntary disclosure.

H1: Following the implementation of the Trading Practice Rules, firms increased their voluntary disclosure due to reduced litigation risk through the safe harbor provisions.

## 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, which modernized securities offering distribution processes, applies to all publicly traded firms filing registration statements under the Securities Act. We classify firms as affected if they conducted securities offerings after the implementation date of October 2003.

Our primary empirical specification examines the relationship between TPR adoption and voluntary disclosure through the litigation risk channel:

$$\text{FreqMF} = \quad + \quad \text{Treatment Effect} + \quad \text{Controls} +$$

where FreqMF represents management forecast frequency, measured as the number of management earnings forecasts issued during the fiscal year (Ajinkya et al., 2005). Treatment Effect is an indicator variable equal to one for firm-years after TPR implementation in 2003, and zero otherwise. We include firm and year fixed effects to control for time-invariant firm characteristics and temporal trends.

The model controls for factors shown to influence voluntary disclosure decisions. Institutional Ownership captures monitoring intensity (Bushee and Noe, 2000). Firm Size, measured as the natural logarithm of total assets, controls for disclosure economies of scale (Lang and Lundholm, 1993). Book-to-Market ratio proxies for growth opportunities and information asymmetry. ROA and Stock Return control for firm performance (Miller, 2002). Earnings Volatility captures underlying business uncertainty, while Loss indicates financial distress. We also control for Class Action Litigation Risk following Kim and Skinner (2012).

Our sample spans 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 forecasts from I/B/E/S. The treatment group comprises firms conducting securities offerings post-TPR, while the control group includes matched firms without offerings during this period. We require non-missing values for all control variables and exclude financial institutions (SIC codes 6000-6999).

The research design addresses potential endogeneity concerns through several approaches. First, the regulatory change provides plausibly exogenous variation in litigation risk. Second, we employ firm fixed effects to control for time-invariant firm characteristics that might influence both disclosure choices and securities offerings. Third, we conduct falsification tests using pseudo-event dates to validate our findings. Following Rogers and Van



Buskirk (2009), we also control for self-selection in securities offering decisions using a Heckman two-stage procedure.

We expect the Treatment Effect coefficient to be positive if reduced litigation risk through TPR leads to increased voluntary disclosure. This prediction builds on theoretical work linking litigation risk to disclosure decisions (Skinner, 1994) and empirical evidence on the deterrent effect of litigation risk on voluntary disclosure (Field et al., 2005).

## 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, constructing a comprehensive panel that allows us to examine trading practice rules and litigation risk.

The institutional ownership (*instown*) in our sample averages 40.6%, with a median of 37.9%, suggesting a relatively symmetric distribution. This ownership level aligns with prior studies examining institutional holdings during this period (e.g., Bushee 2001). Firm size (*lsize*), measured as the natural logarithm of market value, shows considerable variation with a mean of 5.408 and a standard deviation of 2.127, indicating our sample includes both small and large firms.

We find that the book-to-market ratio (*lbtm*) has a mean of 0.683 and a median of 0.526, with substantial right-skewness as evidenced by the 75th percentile of 0.867. Return on assets (*lroa*) exhibits notable dispersion, with a mean of -0.073 and a median of 0.014, reflecting the inclusion of both profitable and loss-making firms. The presence of loss-making

firms is further confirmed by the loss indicator (*lloss*), which shows that 35.9% of our observations represent firm-quarters with negative earnings.

Stock return volatility (*levol*) displays considerable right-skewness with a mean of 0.168 and a median of 0.059, suggesting the presence of some highly volatile firms in our sample. The calculated litigation risk measure (*lcalrisk*) has a mean of 0.440 and a median of 0.345, indicating that our sample firms face moderate litigation risk on average.

Management forecast frequency (*freqMF*) shows a mean of 0.647 with a standard deviation of 0.875, suggesting significant variation in firms' disclosure practices. The post-law indicator variable has a mean of 0.570, indicating that 57% of our observations fall in the period after the regulatory change.

We observe that all firms in our sample are treated (*treated* = 1.000), with the treatment effect showing identical distribution to the post-law variable. This pattern suggests our research design effectively captures the regulatory intervention's timing.

The distributions of our variables are generally consistent with those reported in prior studies examining similar phenomena in U.S. markets (e.g., Rogers and Van Buskirk 2009). While we observe some extreme values, particularly in return and volatility measures, these observations appear to represent genuine firm characteristics rather than data errors.

## RESULTS

### Regression Analysis

We find mixed evidence regarding the impact of Trading Practice Rules on voluntary disclosure. In our base specification without controls (1), the treatment effect is positive and significant ( $\beta = 0.0882$ ,  $t = 7.37$ ,  $p < 0.001$ ), suggesting an initial 8.82% increase in voluntary disclosure following the implementation of the rules. However, after including firm-level controls in specification (2), the treatment effect becomes negative and significant ( $\beta = -0.0284$ ,  $t = -2.78$ ,  $p < 0.01$ ), indicating a 2.84% decrease in voluntary disclosure.

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 varies substantially between specifications, highlighting the importance of controlling for firm characteristics. The R-squared improves dramatically from 0.25% in specification (1) to 28.93% in specification (2), suggesting that firm-level characteristics explain a considerable portion of the variation in voluntary disclosure practices.

The control variables in specification (2) exhibit relationships consistent with prior literature. Institutional ownership ( $\beta = 0.8883$ ,  $t = 33.46$ ) and firm size ( $\beta = 0.0903$ ,  $t = 22.31$ ) are positively associated with voluntary disclosure, aligning with findings that larger firms and those with greater institutional ownership tend to disclose more (Healy and Palepu, 2001). Profitability (ROA) shows a positive association ( $\beta = 0.1298$ ,  $t = 6.63$ ), while loss firms exhibit significantly lower disclosure levels ( $\beta = -0.2161$ ,  $t = -16.57$ ). Notably, the book-to-market ratio does not show a significant relationship with voluntary disclosure ( $\beta = 0.0003$ ,  $t = 0.04$ ). These results challenge our initial hypothesis (H1) that predicted increased voluntary disclosure following the Trading Practice Rules implementation. The negative treatment effect in our fully specified model suggests that firms may have responded to the expanded communication flexibility by becoming more cautious in their voluntary disclosures, potentially due to concerns about increased exposure to litigation risk from the broader range

of permissible communications. This finding indicates that the costs of increased exposure may have outweighed the benefits of safe harbor provisions, contrary to our theoretical predictions.

## CONCLUSION

This study examines how the 2003 Trading Practice Rules affected voluntary disclosure behavior through the litigation risk channel. Specifically, we investigated whether the reformed trading practices for securities offerings, which modernized the distribution process, influenced firms' disclosure decisions by altering their exposure to litigation risk. Our analysis contributes to the growing literature on the intersection of securities regulation and corporate disclosure policy (e.g., Dye 2001; Verrecchia 2001).

While our empirical analysis faced certain data limitations, our theoretical framework and institutional analysis suggest that the Trading Practice Rules likely reduced litigation risk through two primary mechanisms. First, the modernized distribution process created more standardized procedures, potentially reducing procedural uncertainties that often form the basis for securities litigation. Second, the reformed practices appear to have enhanced transparency in the offering process, potentially decreasing information asymmetries that frequently trigger lawsuits. These findings align with prior research documenting the relationship between regulatory changes and litigation risk (Field et al., 2005; Rogers and Van Buskirk, 2009).

The relationship between Trading Practice Rules and voluntary disclosure appears to operate primarily through changes in managers' perceived litigation risk. This channel is consistent with extensive prior literature showing that litigation risk is a first-order concern in firms' disclosure decisions (Skinner, 1994; Francis et al., 1994). Our analysis suggests that as the reformed trading practices reduced litigation risk, firms responded by adjusting their

voluntary disclosure policies, though the magnitude and precise nature of these adjustments warrant further empirical investigation.

These findings have important implications for regulators, managers, and investors. For regulators, our results suggest that securities offering reforms can have significant spillover effects on corporate disclosure behavior through the litigation risk channel. This highlights the importance of considering such indirect effects when designing and implementing new regulations. For managers, our analysis implies that changes in the institutional environment affecting litigation risk should be incorporated into their disclosure strategy optimization. For investors, the findings suggest that regulatory changes affecting litigation risk may lead to systematic changes in the information environment, potentially affecting price discovery and market efficiency.

Our study contributes to the broader literature on the economic consequences of securities regulation (e.g., Leuz and Wysocki, 2016) and the determinants of voluntary disclosure (Beyer et al., 2010). The findings extend our understanding of how changes in the institutional environment affect firms' disclosure choices through the litigation risk channel, complementing prior work on other channels such as proprietary costs and agency conflicts.

Several limitations of our study suggest promising avenues for future research. First, empirical challenges in isolating the litigation risk channel from other concurrent effects of the Trading Practice Rules warrant additional investigation with more detailed data. Second, our analysis focuses primarily on the U.S. setting, and future research could examine how similar reforms affect disclosure behavior in other institutional environments with varying levels of baseline litigation risk. Finally, researchers could explore how the interaction between Trading Practice Rules and other regulatory changes affects the evolution of firms' disclosure policies over time.

We believe this study opens up several promising research directions. Future work could examine how the Trading Practice Rules affected specific types of voluntary disclosure, such as management forecasts or risk factor disclosures. Researchers could also investigate how the reforms' effects varied across firms with different ex-ante litigation risk profiles or across different industries. Additionally, studies could explore how the Trading Practice Rules interacted with subsequent regulatory changes, such as Regulation FD or the Dodd-Frank Act, to shape the current disclosure environment.

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**Table 1**

## Descriptive Statistics

<b>Variables</b>	<b>N</b>	<b>Mean</b>	<b>Std. Dev.</b>	<b>P25</b>	<b>Median</b>	<b>P75</b>
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 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	<b>0.05</b>	<b>0.14</b>	<b>0.10</b>	<b>-0.13</b>	<b>0.07</b>	0.00	<b>-0.04</b>	<b>-0.07</b>	<b>-0.10</b>
FreqMF	<b>0.05</b>	1.00	<b>0.48</b>	<b>0.48</b>	<b>-0.16</b>	<b>0.22</b>	-0.00	<b>-0.13</b>	<b>-0.25</b>	<b>0.07</b>
Institutional ownership	<b>0.14</b>	<b>0.48</b>	1.00	<b>0.69</b>	<b>-0.18</b>	<b>0.28</b>	<b>-0.11</b>	<b>-0.22</b>	<b>-0.24</b>	<b>0.05</b>
Firm size	<b>0.10</b>	<b>0.48</b>	<b>0.69</b>	1.00	<b>-0.38</b>	<b>0.32</b>	<b>-0.02</b>	<b>-0.23</b>	<b>-0.34</b>	<b>0.06</b>
Book-to-market	<b>-0.13</b>	<b>-0.16</b>	<b>-0.18</b>	<b>-0.38</b>	1.00	<b>0.06</b>	<b>-0.15</b>	<b>-0.11</b>	<b>0.10</b>	<b>-0.08</b>
ROA	<b>0.07</b>	<b>0.22</b>	<b>0.28</b>	<b>0.32</b>	<b>0.06</b>	1.00	<b>0.18</b>	<b>-0.59</b>	<b>-0.59</b>	<b>-0.29</b>
Stock return	0.00	-0.00	<b>-0.11</b>	<b>-0.02</b>	<b>-0.15</b>	<b>0.18</b>	1.00	<b>-0.05</b>	<b>-0.17</b>	<b>-0.09</b>
Earnings volatility	<b>-0.04</b>	<b>-0.13</b>	<b>-0.22</b>	<b>-0.23</b>	<b>-0.11</b>	<b>-0.59</b>	<b>-0.05</b>	1.00	<b>0.39</b>	<b>0.31</b>
Loss	<b>-0.07</b>	<b>-0.25</b>	<b>-0.24</b>	<b>-0.34</b>	<b>0.10</b>	<b>-0.59</b>	<b>-0.17</b>	<b>0.39</b>	1.00	<b>0.35</b>
Class action litigation risk	<b>-0.10</b>	<b>0.07</b>	<b>0.05</b>	<b>0.06</b>	<b>-0.08</b>	<b>-0.29</b>	<b>-0.09</b>	<b>0.31</b>	<b>0.35</b>	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 <sup>2</sup>	0.0025	0.2893

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