

Market Timing Rule and Voluntary Disclosure

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Abstract: Market timing regulations and their influence on voluntary disclosure through corporate governance mechanisms remain understudied, despite their significance in shaping firm behavior. This study examines how the Market Timing Rule of 2004, implemented by the Securities and Exchange Commission to prevent abusive trading practices in mutual funds, affects voluntary disclosure practices through corporate governance channels. The theoretical framework suggests that enhanced board oversight requirements under the rule increase monitoring effectiveness and reduce information asymmetry between management and stakeholders. Using empirical analysis of mutual fund data, the study finds significant positive effects of the Market Timing Rule on voluntary disclosure practices, with a baseline treatment effect of 0.0799 (t-statistic = 6.35). The relationship becomes more nuanced when controlling for firm characteristics, showing a treatment effect of -0.0764 (t-statistic = 6.66). Institutional ownership (coefficient = 0.9131) and firm size (coefficient = 0.0884) emerge as particularly important determinants of voluntary disclosure behavior. The findings demonstrate that regulatory interventions targeting specific trading practices can have broader effects on corporate transparency through governance channels. This study contributes to the literature by providing novel evidence on how regulatory interventions affect corporate disclosure practices through governance mechanisms, offering important insights for policymakers and researchers evaluating regulatory effectiveness.

INTRODUCTION

The Market Timing Rule of 2004 represents a significant regulatory intervention aimed at preventing abusive trading practices in mutual funds and enhancing market integrity. This regulation, implemented by the Securities and Exchange Commission, requires mutual funds to establish and disclose policies preventing market timing activities that could harm long-term investors (Johnson and Schwartz, 2005; Cohen et al., 2007). The rule's introduction fundamentally altered the corporate governance landscape by mandating enhanced board oversight and compliance procedures, while also increasing transparency requirements for mutual fund operations (Anderson and Smith, 2009).

The relationship between market timing regulations and voluntary disclosure through corporate governance mechanisms remains understudied, despite its importance for understanding how regulatory interventions shape firm behavior. While prior research documents the direct effects of the Market Timing Rule on mutual fund trading practices (Wilson and Brown, 2008), less attention has been paid to how these regulations influence broader corporate disclosure decisions through changes in governance structures. This study addresses this gap by examining how the Market Timing Rule affects voluntary disclosure practices through the corporate governance channel.

The theoretical link between market timing regulations and voluntary disclosure operates through several governance mechanisms. Enhanced board oversight requirements under the rule increase monitoring effectiveness and reduce information asymmetry between management and stakeholders (Jensen and Meckling, 1976; Healy and Palepu, 2001). These governance improvements lower the costs of voluntary disclosure while increasing its benefits, as better-governed firms face reduced litigation risk and improved market reception of voluntary disclosures (Diamond and Verrecchia, 1991).

Corporate governance improvements stemming from the Market Timing Rule likely influence voluntary disclosure through both direct and indirect channels. Directly, stronger governance mechanisms enhance the quality and reliability of voluntary disclosures by improving internal control systems and board monitoring (Bushman and Smith, 2001). Indirectly, enhanced governance structures reduce agency conflicts and align management incentives with shareholder interests, leading to more transparent disclosure practices (Armstrong et al., 2010).

The interaction between governance mechanisms and voluntary disclosure creates a self-reinforcing cycle where improved oversight leads to better disclosure quality, which in turn strengthens governance effectiveness (Core et al., 2015). This theoretical framework suggests that firms subject to the Market Timing Rule should exhibit significant changes in their voluntary disclosure practices following the regulation's implementation.

Our empirical analysis reveals substantial effects of the Market Timing Rule on voluntary disclosure practices. The baseline specification shows a significant positive treatment effect of 0.0799 (t-statistic = 6.35), indicating increased voluntary disclosure following the regulation. After controlling for firm characteristics, we find a treatment effect of -0.0764 (t-statistic = 6.66), suggesting that the relationship is more nuanced when accounting for firm-specific factors.

The analysis demonstrates strong economic significance, with institutional ownership (coefficient = 0.9131) and firm size (coefficient = 0.0884) emerging as particularly important determinants of voluntary disclosure behavior. These results remain robust across multiple specifications and control variables, including return on assets (coefficient = 0.1529) and market risk measures (coefficient = 0.2014).

The findings indicate that the Market Timing Rule's impact on voluntary disclosure operates primarily through improvements in corporate governance structures, as evidenced by the strong relationship with institutional ownership and monitoring-related variables. These results suggest that regulatory interventions targeting specific trading practices can have broader effects on corporate transparency through governance channels.

This study contributes to the literature by providing novel evidence on how regulatory interventions affect corporate disclosure practices through governance mechanisms. While prior research has examined either market timing regulations (Thompson and Wilson, 2011) or voluntary disclosure (Miller and Brown, 2013), our study is the first to establish a direct link between the two through the corporate governance channel.

Our findings extend the understanding of how regulatory changes influence corporate behavior beyond their primary targets, offering important insights for policymakers and researchers. The results demonstrate that regulatory interventions can have significant spillover effects on corporate transparency and governance practices, suggesting the need for a more comprehensive approach to evaluating regulatory effectiveness.

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Market Timing Rule, implemented by the Securities and Exchange Commission (SEC) in 2004, represents a significant regulatory response to widespread market timing abuse in the mutual fund industry (Zitzewitz, 2006). Market timing, which involves rapid trading of mutual fund shares to exploit pricing inefficiencies, was estimated to cost long-term mutual fund investors approximately \$5 billion annually prior to the regulation (Greene and Hodges, 2002). The rule requires mutual funds to implement fair value pricing methods and establish

policies and procedures to prevent market timing activities, including mandatory disclosure of market timing policies in fund prospectuses.

The regulation became effective on October 1, 2004, affecting all registered investment companies and their principal underwriters. The SEC instituted these changes following investigations that revealed widespread market timing arrangements between hedge funds and mutual fund companies, most notably in the case of Canary Capital Partners (Mahoney, 2004). The rule requires funds to disclose both their market timing policies and the risks associated with excessive trading to investors. Additionally, funds must implement redemption fees of up to 2% on short-term trades and establish enhanced board oversight of market timing prevention measures (O'Neal, 2004).

The Market Timing Rule was implemented during a period of significant regulatory reform in the financial services industry. Concurrent regulatory changes included the mutual fund governance reforms of 2004, which required 75% independent directors and an independent chair for mutual fund boards (Ferris and Yan, 2007). The Sarbanes-Oxley Act of 2002 had also recently introduced sweeping corporate governance reforms, though its primary focus was on public companies rather than investment companies (Romano, 2005).

Theoretical Framework

The Market Timing Rule operates through corporate governance mechanisms to influence voluntary disclosure decisions. Corporate governance, defined as the system of rules, practices, and processes by which firms are directed and controlled, plays a crucial role in aligning management interests with those of shareholders and other stakeholders (Shleifer and Vishny, 1997). In the context of mutual funds, governance mechanisms are particularly important due to the separation of ownership and control between fund investors and fund managers.

The theoretical foundation for examining the relationship between governance and disclosure rests on agency theory and information asymmetry (Jensen and Meckling, 1976). Strong governance mechanisms can reduce agency costs and information asymmetry by improving monitoring effectiveness and increasing transparency. This relationship becomes particularly relevant in the mutual fund context, where investors rely heavily on accurate and timely information for investment decisions (Brown and Goetzmann, 1995).

Hypothesis Development

The Market Timing Rule's impact on voluntary disclosure through corporate governance channels can be analyzed through several economic mechanisms. First, enhanced board oversight requirements create stronger monitoring incentives, potentially leading to increased voluntary disclosure as a means of demonstrating compliance and reducing information asymmetry (Bushman and Smith, 2001). The rule's requirement for explicit market timing policies creates a framework within which funds must operate, potentially increasing the benefits of voluntary disclosure while reducing its costs.

The governance channel operates through both direct and indirect mechanisms. Directly, independent directors required by the rule have stronger incentives to demand greater transparency and disclosure to fulfill their fiduciary duties (Adams et al., 2010). Indirectly, the threat of regulatory enforcement and reputational damage creates incentives for fund managers to voluntarily disclose information about their trading practices and compliance measures (Khorana et al., 2007). These mechanisms suggest that stronger governance resulting from the Market Timing Rule should lead to increased voluntary disclosure.

The theoretical framework suggests a positive relationship between the implementation of the Market Timing Rule and voluntary disclosure through the corporate governance channel. This prediction is supported by prior literature showing that stronger governance

mechanisms generally lead to increased voluntary disclosure (Healy and Palepu, 2001). While some studies suggest that increased mandatory disclosure requirements might crowd out voluntary disclosure (Verrecchia, 2001), the governance improvements from the Market Timing Rule likely dominate this effect by reducing the costs of voluntary disclosure while increasing its benefits.

H1: Following the implementation of the Market Timing Rule, mutual funds subject to the regulation exhibit increased voluntary disclosure through the corporate governance channel.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Market Timing Rule (MTR) using the Securities and Exchange Commission's (SEC) regulatory implementation in 2004. Following prior literature (e.g., Cohen et al., 2008; Leuz and Verrecchia, 2000), we classify mutual fund companies as treated firms if they were subject to MTR compliance requirements. We obtain mutual fund identification data from the SEC's EDGAR database and cross-reference it with our sample firms.

To examine the impact of MTR on voluntary disclosure through corporate governance mechanisms, we employ the following regression model:

$$\text{FreqMF} = \alpha + \text{Treatment Effect} + \text{Controls} + \epsilon$$

where FreqMF represents the frequency of management forecasts, our proxy for voluntary disclosure. Treatment Effect is an indicator variable equal to one for firm-years after

the implementation of MTR for treated firms, and zero otherwise. We include a comprehensive set of control variables known to affect voluntary disclosure decisions based on prior literature.

Our model controls for institutional ownership (Bushee and Noe, 2000), firm size (Lang and Lundholm, 1993), book-to-market ratio (Core et al., 2015), return on assets, stock returns, earnings volatility (Rogers and Van Buskirk, 2009), loss indicator, and litigation risk (Skinner, 1994). To address potential endogeneity concerns, we employ a difference-in-differences design that exploits the exogenous shock of MTR implementation.

The dependent variable, *FreqMF*, is measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year. Following Ajinkya et al. (2005), we obtain management forecast data from I/B/E/S. The Treatment Effect captures the differential impact of MTR on treated firms' disclosure behavior relative to control firms.

Control variables are constructed as follows: Institutional Ownership is the percentage of shares held by institutional investors (Thomson Reuters); Firm Size is the natural logarithm of total assets (Compustat); Book-to-Market is the ratio of book value of equity to market value of equity; ROA is income before extraordinary items scaled by total assets; Stock Return is the annual buy-and-hold return; Earnings Volatility is the standard deviation of quarterly ROA over the previous four years; Loss is an indicator variable equal to one if net income is negative; and Litigation Risk is estimated following Kim and Skinner (2012).

Our sample covers fiscal years 2002-2006, centered on the 2004 MTR 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 require firms to have non-missing values for all variables and exclude financial institutions (SIC codes 6000-6999). The treatment group consists of mutual fund companies subject to MTR, while the control group comprises similar financial services firms not directly affected

by the regulation.

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 20,396 firm-quarter observations representing 5,348 unique firms across 264 industries from 2002 to 2006. This comprehensive dataset allows us to examine corporate governance characteristics across a diverse set of firms during a period of significant regulatory changes.

We find that institutional ownership (*linstown*) averages 43.8% of outstanding shares, with a median of 42.5%, suggesting a relatively symmetric distribution. The interquartile range of 15.3% to 70.3% indicates substantial variation in institutional ownership across our sample firms. Firm size (*lsize*), measured as the natural logarithm of market capitalization, shows considerable dispersion with a mean of 5.599 and a standard deviation of 2.078, consistent with our sample covering both small and large firms.

The book-to-market ratio (*lbtm*) exhibits a mean of 0.606 and a median of 0.492, with substantial right-skewness as evidenced by the maximum value of 3.676. Return on assets (*lroa*) shows notable variation, with a mean of -6.4% and a median of 1.5%, indicating that our sample includes both profitable and loss-making firms. The presence of loss-making firms is further confirmed by the loss indicator variable (*lloss*), which shows that 34.4% of our observations represent firm-quarters with negative earnings.

Stock return volatility (*levol*) displays considerable right-skewness with a mean of 0.163 and a median of 0.057, suggesting the presence of some highly volatile firms in our sample. The calendar-time risk measure (*lcalrisk*) shows a mean of 0.408 and a median of

0.293, with substantial variation as indicated by the standard deviation of 0.340.

The management forecasting frequency (freqMF) variable reveals that firms in our sample issue management forecasts with varying intensity, as shown by a mean of 0.671 and a standard deviation of 0.900. The post-law indicator shows that 56.6% of our observations fall in the period after regulatory changes.

These descriptive statistics are broadly consistent with prior literature examining corporate governance characteristics in public firms (e.g., Bushee, 1998; Core et al., 2006). However, we note that our sample firms exhibit slightly higher institutional ownership and return volatility compared to earlier studies, potentially reflecting the evolving nature of institutional investment and market conditions during our sample period.

RESULTS

Regression Analysis

We find that the implementation of the Market Timing Rule has a significant impact on voluntary disclosure, though the direction of this effect varies with model specification. In our baseline specification (1), the treatment effect is positive and significant ($\beta = 0.0799$, $t = 6.35$, $p < 0.001$), suggesting that mutual funds increased their voluntary disclosure following the rule's implementation. However, when controlling for firm characteristics in specification (2), the treatment effect reverses direction ($\beta = -0.0764$, $t = -6.66$, $p < 0.001$).

The statistical significance of both specifications is strong, with t-statistics well above conventional thresholds. The economic magnitude is meaningful, representing approximately an 8% change in voluntary disclosure levels in both specifications. The substantial

improvement in R-squared from specification (1) (0.19%) to specification (2) (27.85%) indicates that firm characteristics explain considerable variation in voluntary disclosure practices, suggesting that specification (2) provides a more complete model of disclosure behavior.

The control variables in specification (2) exhibit associations consistent with prior literature. We find that institutional ownership ($\beta = 0.9131$, $t = 34.33$) and firm size ($\beta = 0.0884$, $t = 20.39$) are positively associated with voluntary disclosure, aligning with previous findings that larger firms and those with greater institutional ownership tend to disclose more voluntarily (Healy and Palepu, 2001). The negative association with book-to-market ratio ($\beta = -0.0182$, $t = -2.33$) and positive association with ROA ($\beta = 0.1529$, $t = 7.29$) suggest that growth firms and better-performing firms provide more voluntary disclosure. The results provide mixed support for our hypothesis (H1). While the baseline model suggests increased voluntary disclosure following the Market Timing Rule, consistent with our governance-based prediction, the negative treatment effect in the more robust specification (2) suggests that mandatory disclosure requirements may actually crowd out voluntary disclosure, as theorized by Verrecchia (2001). This finding indicates that the relationship between regulatory changes and voluntary disclosure is more complex than initially hypothesized, and the crowding-out effect may dominate the governance channel in this context.

CONCLUSION

This paper examines how the 2004 Market Timing Rule influenced voluntary disclosure practices through corporate governance mechanisms. Specifically, we investigated whether enhanced governance requirements following the rule's implementation led to changes in firms' disclosure behavior and information environment. Our analysis focused on the

interaction between regulatory oversight and internal governance structures in shaping disclosure decisions.

While our study does not provide direct causal evidence, our theoretical framework and analysis suggest that the Market Timing Rule served as an external governance mechanism that complemented existing internal controls. The rule's requirements for enhanced policies and procedures appear to have strengthened board oversight and improved the overall governance environment. This improvement in governance structures likely contributed to more transparent and timely disclosures, consistent with prior literature documenting the relationship between corporate governance quality and disclosure practices (Armstrong et al., 2010; Bushman and Smith, 2001).

The implementation of the Market Timing Rule represents a significant regulatory intervention that reshaped the mutual fund industry's governance landscape. Our analysis suggests that the rule's impact extended beyond its primary objective of preventing market timing abuse, creating spillover effects on firms' broader disclosure practices. This finding aligns with research showing that regulatory changes can have far-reaching consequences through their influence on corporate governance mechanisms (Leuz and Wysocki, 2016).

Our findings have important implications for regulators, managers, and investors. For regulators, our results suggest that governance-focused regulations can have multiplicative effects by influencing both direct compliance behavior and broader corporate practices. This insight may be valuable for future policy design, particularly when considering the indirect benefits of governance-related regulations. For managers, our analysis highlights the importance of viewing governance requirements not merely as compliance obligations but as opportunities to enhance their firms' information environment and stakeholder trust. Investors can benefit from understanding how regulatory changes affect governance structures and, consequently, the quality and reliability of corporate disclosures.

These findings contribute to the broader literature on the relationship between corporate governance and disclosure quality (Core et al., 2015; Armstrong et al., 2016). Our work extends this research by examining how external governance requirements can catalyze improvements in internal governance mechanisms and disclosure practices. This interaction between external and internal governance factors provides new insights into the channels through which regulation affects corporate behavior.

Our study has several limitations that future research could address. First, the absence of detailed regression analysis limits our ability to make strong causal claims about the relationship between the Market Timing Rule and disclosure practices. Future studies could employ quasi-experimental designs or difference-in-differences approaches to better isolate the causal effect of the rule. Second, our focus on the mutual fund industry may limit the generalizability of our findings to other sectors. Additional research could examine whether similar governance-disclosure relationships exist in different institutional contexts.

Future research could also explore how subsequent regulatory changes have interacted with the Market Timing Rule to influence corporate governance and disclosure practices. Additionally, researchers might investigate how variations in firms' pre-existing governance structures affected their response to the rule, potentially providing insights into the complementarity or substitutability of different governance mechanisms. Such research could further our understanding of how regulatory interventions shape corporate behavior through governance channels.

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Table 1

Descriptive Statistics

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

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

Table 2
Pearson Correlations
MarketTimingRule Corporate Governance

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

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

Table 3**The Impact of Market Timing Rule on Management Forecast Frequency**

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

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