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Legal Sidebar

Stock Buybacks: Background and Reform Proposals

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In 2018, U.S. corporations announced plans to buyback a record $1.08 trillion of their own stock—a trend that has attracted scrutiny and generated a number of legislative proposals designed to curb the practice's prevalence. This Legal Sidebar provides a general overview of the regulatory framework surrounding stock buybacks and these recent reform proposals. The Sidebar (1) reviews the debate over the social value of stock buybacks, (2) discusses the regulatory regime surrounding buybacks, and (3) examines a number of proposals to reform this framework that have been proposed in legislation, popular commentary, and the academic literature.

The Debate

When publicly traded corporations seek to return money to their shareholders, they have two options: (1) pay shareholders a cash dividend, or (2) repurchase shares of their own stock and thereby drive share prices higher. The choice between paying a dividend and repurchasing stock involves a variety of considerations. In theory, corporate managers may pay a dividend instead of initiating a buyback when they believe their company's stock is overvalued. Dividends also provide shareholders with the ability to remain invested in a company while receiving a regular income stream. By contrast, corporate managers may prefer stock buybacks over dividends because of tax considerations (dividends are taxable, while unrealized capital gains are not), a belief that their company's stock is undervalued, a desire to reorient their company's capital structure away from equity and towards debt financing, or (more controversially) because buybacks can help managers meet short-term share price targets.

The use of stock buybacks to distribute excess cash has increased significantly since the early 1980s, both in absolute terms and in comparison with the payment of dividends. In 1980, U.S. corporations repurchased $6.6 billion of their own stock. By 2000, that amount had grown to roughly $200 billion—still a far cry from the over $1 trillion in buybacks announced last year. Moreover, although 80 to 90

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percent of cash payouts by publicly traded corporations took the form of dividends before the early 1980s, S&P 500 companies spent 54 percent of their net income on buybacks between 2003 and 2012, while paying out only 37 percent as dividends.

This surge in the volume of buybacks has generated scrutiny from a number of lawmakers, regulators, and financial market professionals. Some critics have argued that buybacks represent a form of short-term financial engineering that harms long-term shareholder value. According to these observers, corporate executives use buybacks to meet short-term financial targets instead of making long-term investments in capital assets and research and development (R&D).

Other critics have contended that unlike the payment of dividends, buybacks redistribute a firm's value from public shareholders to corporate insiders. Specifically, some commentators have argued that because corporate insiders often own a significant fraction of their firms' equity, stock buybacks can function as a form of "indirect" insider trading that, like traditional insider trading, redistributes a company's value from public investors to insiders. According to these observers, corporate insiders often initiate buyback programs based on inside information suggesting that their company's stock is undervalued, thereby diverting value from public shareholders who sell their stock to non-selling shareholders, including the insiders themselves. Other commentators have identified a different channel for this sort of redistribution, arguing that corporate insiders often use buybacks to "cash out" their equity compensation by selling their shares of a company's stock shortly after buyback announcements. According to an analysis of stock buybacks initiated between January 2017 and March 2018, corporate executives sold an average of $500,000 of their company's stock per day immediately following a buyback announcement, compared with less than $100,000 in the days immediately preceding such an announcement.

Finally, some legislators and analysts have contended that increased levels of stock buybacks exacerbate economic inequality by benefiting shareholders at the expense of workers, who they argue would receive higher wages in the absence of such payouts.

However, these criticisms of stock buybacks are controversial. Defenders of buybacks have argued that when a company repurchases its own stock, it promotes the efficient allocation of capital by redistributing excess cash to more productive uses. Other commentators have rejected the argument that buybacks promote unhealthy short-termism on the part of corporate management, contending that (1) U.S. corporations have largely offset the effects of buybacks with new issues of low-interest debt (which offers certain tax advantages), leaving their cash positions basically unchanged, (2) U.S. corporate R&D spending is rising, and (3) recent declines in capital expenditures are the result of broader macroeconomic trends, rather than an increase in the volume of buybacks. Finally, some observers have rejected the argument that buybacks contribute to growing economic inequality, arguing that a healthy stock market benefits the middle class by increasing the value of retirement portfolios, pension funds, and college savings accounts. These commentators have further questioned whether a decline in buybacks would in fact lead to higher wages, arguing that companies that do not repurchase their shares may instead pay out excess cash as dividends or make long-term capital investments, neither of which necessarily increases worker pay.

Regulatory Background

This policy debate takes place in the context of a regulatory framework surrounding stock buybacks consisting of three general categories of rules: (1) disclosure requirements, (2) prohibitions on market manipulation, coupled with SEC Rule 10b-18's safe harbor for buybacks that meet certain conditions, and (3) SEC Rule 10b-5's prohibition on insider trading.

Disclosure Requirements

In 2003, the Securities and Exchange Commission (SEC) promulgated regulations requiring companies that conduct stock buybacks to make certain retrospective disclosures. Under these regulations, companies that repurchase their own stock must disclose in their quarterly public filings: (1) the total number of shares repurchased during the previous quarter, (2) the average price paid for those shares, (3) the number of shares repurchased during the previous quarter as part of a publicly announced repurchase plan, and (4) the maximum number (or approximate dollar value) of shares that may yet be purchased under the plan. However, SEC regulations do not mandate prospective disclosures of either the volume or expiration date of buyback programs, meaning that investors may not learn precise details about such programs until months after they are initiated.

Market Manipulation

Section 9(a)(2) of the Securities Exchange Act of 1934 (the Exchange Act) prohibits various forms of market manipulation, making it unlawful to conduct securities transactions with the intent to deceive investors by controlling or artificially affecting the price of a security. While the boundaries of manipulative conduct remain difficult to precisely define, stock buybacks might in certain circumstances qualify as market manipulation to the extent that they are intended to artificially drive up the price of a company's stock. Companies seeking to conduct buybacks accordingly operated in "a legally hazy area" for much of the 20th century.

While the SEC proposed a series of rules throughout the 1970s that would have explicitly limited the circumstances in which buybacks were permissible, it ultimately settled on a deregulatory posture toward buybacks in 1982. In that year, the Commission adopted a limited safe harbor from market manipulation liability for stock buybacks in the form of SEC Rule 10b-18. Under Rule 10b-18, companies are immune from market manipulation liability when they repurchase shares in accordance with certain "manner, timing, price, and volume" conditions. Specifically, the Rule 10b-18 safe harbor applies only if companies conducting buybacks (among other things):

1. use a single broker or dealer per day to bid for or purchase their stock;
2. abide by certain timing restrictions intended to prevent them from establishing either the opening or closing price of their stock;
3. not offer a price that exceeds the highest independent bid or the last independent transaction price on the relevant exchange, whichever is higher; and
4. limit their daily repurchases to 25 percent of the average daily trading volume of their securities during the previous month.

The Rule 10b-18 safe harbor does not apply to repurchases made in technical compliance with these requirements that are nevertheless "part of a plan or scheme to evade the federal securities laws." Although the Rule offers a safe harbor from market manipulation liability for stock buybacks that meet these and certain other conditions, it does not affirmatively prohibit buybacks that fail to meet these conditions. According to some commentators, the greater legal certainty provided by Rule 10b-18 has played an integral role in encouraging buybacks, with one study finding that buyback volume tripled in the year after the Rule went into effect.

Insider Trading

Section 10(b) of the Exchange Act and SEC Rule 10b-5 prohibit trading securities on the basis of material non-public information concerning their value—that is, non-public information that a reasonable investor would consider important. Because the Rule 10b-18 safe harbor discussed above applies only to liability for market manipulation, it does not insulate companies from insider trading liability for conducting buybacks on the basis of material non-public information. Moreover, a number of federal courts have held that corporations have a duty to disclose such information to shareholders with whom they trade. While corporations that initiate buybacks on the basis of material non-public information accordingly run the risk of insider trading liability, managers may be able to conduct buybacks on the basis of certain forms of so-called "soft" information (*e.g.*, internal projections) that may not qualify as legally material (though certain types of "soft" information may qualify as material depending on the circumstances).

Reform Proposals

In response to some of the concerns discussed above, a number of lawmakers have proposed overhauling the regulatory regime surrounding stock buybacks. In the 115th Congress, S. 2605, the Reward Work Act, would have prohibited open-market stock repurchases—by far the most common form of buyback—altogether, while also repealing Rule 10b-18. However, the bill would not have prohibited companies from conducting tender offers for their own stock—that is, offers extended to all of a company's shareholders to purchase stock at a specific price, which are subject to more rigorous disclosure requirements than open-market repurchases.

Other proposals would impose certain conditions on companies that conduct buybacks. An ultimately unsuccessful amendment to S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act would have given the SEC the authority to require detailed prospective disclosures regarding buyback plans and their execution, reject buyback plans, and require corporate boards and CEOs to certify that buybacks are in the long-term "best interest" of their companies. Similarly, in February 2019, two Senators announced that they planned to introduce legislation that would prohibit companies from repurchasing their stock unless they meet various preconditions, such as paying workers certain prescribed wages, providing a minimum amount of paid sick leave, and offering "decent pensions and more reliable health benefits." Such measures would echo certain academic proposals that Congress prohibit buybacks by companies that have unfunded pension liabilities, engage in layoffs, fail to engage in certain levels of productive investment, and/or have high CEO-to-median-worker pay ratios. Finally, SEC Commissioner Robert J. Jackson, Jr. has proposed that the Commission amend Rule 10b-18 to deny its safe harbor to companies that allow their executives to sell their shares shortly after a buyback program is announced. However, the full Commission has not initiated rulemaking to implement such a proposal.

Other proposals would alter the tax treatment of stock buybacks. Some legislators have expressed support for taxing buybacks at the same rate as dividends in order to incentivize companies to invest excess cash rather than distribute it to shareholders. While lawmakers have yet to introduce legislation fleshing out the details of this proposal, one commentator has suggested that when a company repurchases its shares, the income tax code should treat all of its shareholders—including those who do not sell—as if they had received a dividend and reinvested the proceeds.

With recent surges in stock buybacks showing no signs of abating, the debate over their social value and the optimal policy response is likely to continue in both Congress and the SEC.