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Communities, and Investors”**

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Thank you, Chairwoman Maloney and Ranking Member Huizenga, for inviting me to speak today. It is an honor to be here. My name is Lenore Palladino, and I am Assistant Professor of Economics & Public Policy at the University of Massachusetts Amherst, a Fellow at the Roosevelt Institute, and Research Associate at the Political Economy Research Institute.

I join you today to discuss the causes and consequences of the rise of stock buybacks. Stock buybacks may sound like a technical matter of corporate finance: Why should it matter whether or not corporations repurchase their own stock? When a company executes a stock buyback, they raise the price of that company's shares for a period of time, but the funds spent on buybacks are then unavailable to be spent on the types of corporate activities that could make the company more productive over the long term: investments in future productivity and in the workforce. Stock buybacks are one of the drivers of our imbalanced economy, in which corporate profits and shareholder payments continue to grow while wages for typical workers stay flat.

Stock buybacks are virtually unregulated, even though Congress has recognized their potential for market manipulation. Importantly, there are currently no meaningful limits to stop executives from using corporate money on stock buybacks to raise share prices for their own short-term gain. Executives are not required to disclose that they have conducted a buyback until the next quarter's filing; meanwhile, there are no substantive limits to stop them from selling their own personal shares in the same quarter as they are conducting buybacks.

Stock buybacks have reached record volume: Corporations spent roughly \$900 billion on them in 2018, and projections for 2019 predict an even higher scale. To put this into perspective, that is nearly a third of our national spending on health care. The volume of stock buybacks explains why more money has flowed out of our public capital markets than has flowed back in, for the nonfinancial sector, in almost all of the last 20 years. Their magnitude explains why even

many on Wall Street are ringing warning bells, saying that executives are prioritizing stock price highs over the kinds of true investment that will lead to long-term prosperity.

Congress and the Securities Exchange Commission (SEC) recognized decades ago that this kind of practice could manipulate the stock market, and before 1982, open-market stock buybacks were functionally impermissible. Rule 10b-18, the stock buyback “safe harbor,” was a sharp departure from the proposals made by the SEC in the 1970s that clearly recognized that a large volume of stock buybacks would manipulate the market. Rule 10b-18 leaves stock buybacks virtually unregulated, allowing companies to spend billions a year with no oversight or accountability. This is out of step with the spirit of our securities laws, which is to “insure the maintenance of fair and honest markets.”¹

Some have argued that stock buybacks serve the stock market by moving capital from companies that have no use for it to companies with a higher need for new funds. This begs the question: Could it really be the case that so few American corporations have innovative ideas, could build up their cash reserves or pay down debt, or invest in their workforce? Or could there be another motivation for the high volume of stock buybacks? Additionally, more money has been flowing out of our public capital markets from stock buybacks than has been flowing back in through new equity issuances (for nonfinancial corporations). Rather than argue about how stock buybacks could recirculate funds around the public markets in theory, it is better to look at who stands to gain the most from their use in practice and what tools of public policy we can use to mitigate the focus inside corporate boardrooms on short-term stock returns at the expense of long-term productivity and prosperity.

This committee is well aware of the long-term stagnation of wages for typical workers, widening wealth gaps, and the continual rise of executive compensation. To give some context to

¹ Securities Exchange Act of 1934 (48 Stat. 881, 15 U.S.C. 78a-78kk)

who benefits from stock buybacks: According to the Federal Reserve's Distributional Financial Accounts, in the first quarter of 2019, the richest 10 percent of households owns 86.8 percent of corporate equities; while the bottom 50 percent owns just 0.8—less than 1 percent of the total value of the stock market.² Meanwhile, companies spending billions on buybacks claim that they cannot afford to pay family-supporting wages to their employees, who largely create the value that allows businesses to conduct stock buybacks in the first place.

Companies are conducting stock buybacks in the midst of layoffs, calls by their workforce for an end to poverty wages, and clear productive uses for corporate funds. According to economist William Lazonick, Boeing spent \$43.1 billion on stock buybacks from 2013 to 2019, raising the company's stock price to a record high just 10 days before the second crash of its 737 MAX. Boeing CEO Muilenburg collects most of his pay through stock or compensation based on financial metrics. Yet the company reportedly avoided spending the estimated \$7 billion it would have needed to engineer a safer plane.³ Less than 10 years after a public sector bailout, GM has spent \$10.6 billion on stock buybacks, while engaging in layoffs and plant closures.⁴ That amounts to \$221,308 for each of the 47,897 active UAW members currently on strike at GM. Walmart spent \$9.2 billion on stock buybacks from August 2018 to July 2019, which, by my calculations, could have been used to give a raise of roughly \$5/ hour to each of its 1 million hourly workers instead.⁵

It is the lack of meaningful regulation of stock buybacks that has permitted their rise. SEC Rule 10b-18, the stock buyback safe harbor, gives companies the go-ahead to spend up to 25 percent of their average daily trading volume on buybacks without liability for market

10/15/19 11:42:00 AM 3. "The Fed - Distributional Financial Accounts," Board of Governors of the Federal Reserve System, accessed October 10, 2019, <https://www.federalreserve.gov/releases/efa/efa-distributional-financial-accounts.htm>.

³ William Lazonick and Mustafa Sakinc, "Make Passengers Safer? Boeing Just Made Shareholders Richer," *The American Prospect*, May 31, 2019. <https://prospect.org/environment/make-passengers-safer-boeing-just-made-shareholders-richer/>.

⁴ General Motors, "Stock Information," Stock Repurchase Program, accessed October 15, 2019, <https://investor.gm.com/stock-information>.

⁵ Walmart 10-Q quarterly reports, accessed October 15, 2019, <https://stock.walmart.com/investors/financial-information/sec-filings/default.aspx>; Lenore Palladino, "Making the Case: How Ending Walmart's Stock Buyback Program Would Help Fix Our High-Profit, Low-Wage Economy," Roosevelt Institute, <https://rooseveltinstitute.org/making-case/>.

manipulation, but it also states that there is no assumption of liability for companies spending above that limit. Furthermore, the SEC does not collect the kind of information necessary to even determine if companies are staying within the safe harbor limit.⁶

I recommend that Congress ban stock buybacks, or in the alternative, place bright-line limits on their use. At minimum, corporate insiders should not be able to personally benefit from the practice, and buybacks should be disclosed immediately.⁷

Stock Buybacks Are Premised on a Flawed Model of Corporate Governance

Before I discuss the particular challenges of stock buybacks and potential legislative solutions, I would like to pull back to the model of the corporation that has justified their extensive use. The practice of stock buybacks is premised on a theory of the corporation known as “shareholder primacy.” This theory holds that shareholders should be the only stakeholder engaged in firm governance, and they are due the profits that the firm does not require for contractual obligations to other stakeholders, such as employees, suppliers, or customers, or for investment purposes.⁸ However, this theory—that shareholders should have sole governing authority because they are the primary risk-takers, because they invest capital with no guarantee of return, and thus the residual claimants of its wealth—is flawed.⁹ Shareholders do, of course, have some appropriate legal claims—they own their shares, which entitles them to an income flow, the right to sell their shares, and a certain set of limited rights to vote for the board of directors and shareholder resolutions,¹⁰ as well as the right to bring a claim for a breach of

⁶ David Dayen, “SEC Admits It’s Not Monitoring Stock Buybacks to Prevent Market Manipulation,” *The Intercept*, August 13, 2015, <https://theintercept.com/2015/08/13/sec-admits-monitoring-stock-buybacks-prevent-market-manipulation/>.

⁷ UAW-GM By the Numbers, accessed October 15, 2019, <https://uaw.org/gmbargaining/>.

⁸ Kent Greenfield, *The Failure of Corporate Law*, 2006, <https://www.press.uchicago.edu/ucp/books/book/chicago/F/bo4134274.html>.

⁹ Lynn Stout, “The Shareholder Value Myth,” *Cornell Law Faculty Publications*, April 19, 2013, <https://scholarship.law.cornell.edu/facpub/771>. (discussing the rise of the ideology of shareholder primacy and its critical flaws as a matter of law).

¹⁰ *Id.*

fiduciary duty.¹¹ However, shareholders are not the sole risk-takers, as other stakeholders also take risks: Employees risk the loss of their sole source of income, and the entire society risks suffering from the negative externalities created by the production process. The Business Roundtable has recently redefined the purpose of the corporation away from shareholder primacy and toward a commitment to all stakeholders, including customers, employees, suppliers, and communities, along with generating long-term value for shareholders.

Stock buybacks are justified under this theory of shareholder primacy on the grounds that shareholders should be “returned” available cash when it has not found another productive use.¹² This flawed theory not only fails to recognize that productive uses properly include other types of corporate expenditures, including increased wages, and demands a long-term time horizon. It also gives rise to expectations by shareholders and executives that unused, and frequently borrowed, resources are “owed” to them as sole and exclusive risk-takers within a firm. Finally, it confuses shareholder purchases of new equity from a company with trading transactions that take place on the secondary market.

The remainder of my testimony will outline the specific harms caused by stock buybacks to a productive and equitable economy.

Stock Buybacks Create the Potential for Stock Price Manipulation

First, stock buybacks create the potential for stock price manipulation in violation of Section 9(a)(2) of the Exchange Act. Most simply, share repurchases may be used to manipulate stock prices because the very nature of buying back stock means that the remaining shares rise in

11. Activist shareholders are able to dominate board elections through the proxy voting system. *See generally* Jang-Sup Shin, “The Subversion of Shareholder Democracy and the Rise of Hedge-Fund Activism,” SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, August 4, 2018), <https://papers.ssrn.com/abstract=3226103>.

12. For a full discussion of the role of investors in providing investment capital to public companies, see William Lazonick, *The Theory of Innovative Enterprise: A Foundation of Economic Analysis* 4–16 (ACAD.-INDUS. RESEARCH NETWORK, Working Paper No. 13-0201, 2013, revised 2015), http://www.theairnet.org/v3/backbone/uploads/2015/08/Lazonick.TIE-Foundations_AIR-WP13.0201.pdf [https://perma.cc/C8J5-429A].

value.¹³ Stock buybacks have become a favorite corporate practice because they are a straightforward and fast mechanism to raise share prices and boost earnings per share (EPS).

Stock buybacks are regulated by the Securities and Exchange Act under Rule 10b-18, which creates a “safe harbor” in which companies are free from risk of liability for manipulation under the Securities and Exchange Act as long as they follow the conditions as laid out in the rule. The conditions concern the volume, manner, price, and timing of repurchases, and disclosure is required on quarterly reports to the SEC.¹⁴

In theory, firms that conduct buybacks within these certain conditions (although there is no assumption of liability if buybacks happen outside those conditions), would not have a manipulative effect on the market. But the main effect of repurchases in the short term is to reduce the number of shares available on the open market for trading, meaning that the value of each remaining share goes up in value. Though there is no practical improvement in the sales of a company’s goods, customer satisfaction, or efficiency gains in the production process, share prices go up through the removal of share volume. At the volume of repurchases seen today, conducted intentionally by corporate executives, it is worth considering whether this could be considered manipulation of share prices.¹⁵ One study has shown that the probability of share repurchases is sharply higher for firms that would have just missed EPS forecasts in the absence of repurchases.¹⁶

Stock Buybacks Create Incentives for Insiders to Sell Their Own Shares for Personal Gain

13. What constitutes market manipulation legally is complex. *See generally* Merritt Fox, Lawrence Glosten, and Gabriel Rauterberg, “Stock Market Manipulation and Its Regulation,” *Articles*, January 1, 2018, <https://repository.law.umich.edu/articles/1978>. *See also* William Lazonick, “Profits Without Prosperity,” *Harvard Business Review*, September 1, 2014, <https://hbr.org/2014/09/profits-without-prosperity>. (describing the rise of stock buybacks and their role in corporate investment decisions).

14. 17 C.F.R. 240.10b-18(b)(1) (2018).

15. Fox, *supra* note 25.

16. Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, “The Real Effects of Share Repurchases,” SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, June 18, 2015), <https://papers.ssrn.com/abstract=2276156>.

The current regulatory regime for stock buybacks creates the potential for corporate executives to personally gain during stock buyback programs. These buybacks create incentives for corporate insiders to sell the shares they own, which can create a substantial conflict of interest. Corporate executives hold large amounts of stock, and their compensation is often tied to an increase in the company's EPS metric. That means that the decision of whether and when to execute a stock buyback can greatly affect his or her compensation. Only corporate insiders know precisely when buybacks are actually conducted, which gives executives a personal incentive to time buybacks so that they can profit off of a rising share price.¹⁷ In other words, insiders have a personal incentive to announce buyback programs that they know will raise share price, because they can then turn around and sell their own personal holdings for profit.

Recent research by SEC Commissioner Robert Jackson Jr., demonstrated that executives are utilizing this loophole, finding that the likelihood of insiders selling shares increased five-fold in the week after the announcement of a repurchase program.¹⁸ This is in stark contrast to the rationale often heard in the corporate finance literature that stock buybacks happen because executives believe that their stock is undervalued. If that were the case, we would expect corporate insiders to be buying stock, rather than selling it, around the time of buyback execution.

In recently published research, I examined the relationship between corporate insider transactions and stock buyback programs and found a strong association between quarters where stock buybacks were occurring (in excess of 1 percent of market value) and high levels of insider transactions (over \$100,000). I conducted an empirical analysis of the relationship between insider sales and stock buybacks and found a statistically significant relationship between an increase in the use of corporate funds for stock buybacks and an increase in corporate executives selling their own personal shares in the same quarter.

17. See Jackson, *supra* note Error! Bookmark not defined..

18. *Id.*

Despite these facts—that stocks constitute a substantial proportion of executives’ pay, and that stock buybacks provide a way for executives to raise their pay by millions of dollars—the rules that govern how a company authorizes stock buyback programs fail to account for this significant conflict of interest. The decision to authorize a new stock buyback program is made by the board of directors.¹⁹ The actual execution of buybacks is left to the executives and financial professionals inside the companies, with no board oversight as to the timing or amount of such buybacks, as long as the buybacks stay within the limit previously authorized. As long as directors are using their best “business judgment” to authorize programs, and there is no other insider trading violations, there is no recourse to hold directors accountable for extremely high repurchase programs.²⁰ Further, executives are required to disclose the monthly volume of actual open-market repurchases, but only after the fact.²¹ This means that longer-term investors who hold a small amount of stock, and who could be disadvantaged by the decision to execute a stock buyback program if it is at the expense of investments that could lead to the company’s long-term growth, have no say whatsoever in the company’s decision-making process, and no access to real-time disclosure about buybacks that could be used for selling decisions.

It is useful to observe specific examples in which corporations have high joint levels of buybacks and insider sales.

- Exxon Mobil: In Q2 of 2008, Exxon Mobil insiders collectively sold \$42 million in personal shares, at the same time the company spent \$8.4 billion on stock buybacks. Insiders purchased zero shares themselves.

19. While stock buybacks do not generally require board action (DGCL § 160), generally boards do approve stock buyback programs. *See generally* James D. Honaker & Eric S. Wilensky, “Dividends, Redemptions and Stock Purchases,” Practical Law Company (2012), <https://www.mnat.com/files/1-519-2507.pdf> [<https://perma.cc/NV4J-YYDD>].

20. *Id.*

21. 17 C.F.R. 229.703 (2018).

- IBM: In Q2 of 2007, IBM insiders collected \$21.5 million from selling off their personal shares while the company spent \$14.6 billion on stock buybacks. Again, insiders elected not to purchase any share themselves.
- Microsoft: In Q4 of 2005, Microsoft insiders sold \$49.5 million in personal shares and purchased zero shares. At the same time the company spent \$7.7 billion on stock buybacks.
- Gilead Sciences: In Q1 of 2016, insiders at Gilead Sciences earned \$37.4 million from selling off their personal shares. The same insiders purchased no shares themselves while the firm spent \$7.4 billion on stock buybacks.

The results suggest that executives may be taking advantage of the regulatory loophole left in the regulation of stock buybacks, and that policymakers should reform the regulations governing stock buybacks and corporate insider share-selling.

Stock Buybacks Have Wide-Ranging Economic & Social Impacts

Next, we must consider the wider social and economic impacts of stock buybacks. Stock buybacks are conducted at the expense of other potential uses of corporate funds and primarily benefit short-term share-sellers who sell their stock after the price goes up, rather than longer-term shareholders who are Americans holding shares for retirement. Two studies demonstrate the harm of stock buybacks to long-term shareholders: Keasler and Byerly show that buyback announcements lead to short-term gains but long-term declines in wealth, and Ayers and Olenick show a causal relationship between buybacks and lower growth rates.²² Another study by Almedia, Fos, and Kronlund showed that the probability of a firm conducting buybacks is

²² Terrill Keasler and Robin T. Byerly, "An Examination of Corporate Stock Buybacks: Do They Really Create Value?", *Economics, Management, and Financial Markets*, 10(4): 11-28.

sharply higher if the firm would have just missed its EPS forecast in the absence of a buyback program.²³

Corporations have variable needs for funds to ensure long-term growth; stock buybacks constitute an opportunity cost for further investment, employee compensation, or the build-up of reserves. Their rise correlates with a long-term decline in corporate investment.²⁴ According to Gutierrez and Philippon, “business investment in the US has been weak relative to measures of profitability, funding costs, and market values since the 2000s.”²⁵ As noted by Senator Marco Rubio, business investment is decreasing—net private domestic investment has fallen from nearly a tenth of US GDP in the mid-1980s to less than half of that in 2018.²⁶ Stock buybacks are rising at the same time that corporate leverage rose to an all-time high: Nonfinancial corporate credit as a percentage of GDP reached 74.9 percent in the first quarter of 2019.²⁷

It is important to keep the scale of spending on stock buybacks in mind: For some of our largest employers, such as Walmart, if corporate funds spent on buybacks were redirected to employee compensation, wage increases could lift low-income workers out of poverty.²⁸ Joint research between the Roosevelt Institute and the National Employment Law Project examined stock buybacks in industries where low-wage workers are concentrated and found that McDonald’s could pay all of its 1.9 million workers almost \$4,000 more a year if the company redirected funds spent on buybacks to workers’ paychecks. Lowe’s, CVS, and Home Depot

²³ Heitor Almedia, Vyacheslav Fos, and Mathias Kronlund, “The Real Effects of Share Repurchases,” *Journal of Financial Economics*, 119 (1) Jan: 168-185.

²⁴ J.W. Mason, “Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment,” The Roosevelt Institute, 2015, <http://rooseveltinstitute.org/wp-content/uploads/2015/09/Disgorge-the-Cash.pdf>.

²⁵ German Gutierrez and Thomas Philippon, “Ownership, Concentration and Investment,” *AEA Papers and Proceedings*, 108: 432-37, <https://www.aeaweb.org/articles?id=10.1257/pandp.20181010>.

²⁶ See Press Release “Rubio Releases Report on Domestic Investment,” US Senator for Florida, Marco Rubio, accessed October 10, 2019, <https://www.rubio.senate.gov/public/index.cfm/2019/5/rubio-releases-report-on-domestic-investment>.

²⁷ Bank for International Settlements, “Total Credit to Non-Financial Corporations,” accessed from FRED, Federal Reserve Bank of St. Louis, October 11, 2019, <https://fred.stlouisfed.org/series/QUSNAM770A>.

²⁸ See Lenore Palladino and Adil Abdela, “Making the Case: How Ending Walmart’s Stock Buyback Program Would Help to Fix Our High-Profit, Low-Wage Economy,” The Roosevelt Institute, May 2018, <https://rooseveltinstitute.org/wp-content/uploads/2018/05/Walmart-issue-brief.pdf>.

could all afford to give their workers raises of at least \$18,000 per year.²⁹ In recent research, I find that for large nonfinancial corporations, there is a statistically significant relationship between a rise in shareholder payments and a decline in reported employee compensation. At the aggregate level, I found that while payments to shareholders have doubled as a percentage of corporate assets over the last 45 years, the wage bill fell from 21 percent of total corporate assets in 1972 to 11 percent in 2017.³⁰

Stock buybacks have an impact on wealth and income inequality. In terms of wealth inequality, stock buybacks only benefit those who hold stock. Less than half of US households own any stock at all, and less than one third of households own at least \$10,000 worth of stock.³¹ Stock ownership is concentrated at the top of the wealth distribution: 93 percent of households in the top 1 percent of households by income own more than \$10,000 of stock.³² Stock ownership reflects broader racial stratification as well: While approximately 60 percent of white households own stock either directly or indirectly, only 34 percent and 30 percent of Black and Latinx households, respectively, hold stock.³³ All of this means that increasing stock value driven by stock buybacks disproportionately benefits wealthier, white households.

Responses to Justifications for Stock Buybacks

Defenders of repurchases argue that buybacks serve an important function by reallocating capital to where it would be most useful.³⁴ Under this theory, when executives determine that they have no investment opportunities where the rate of return is above the cost of capital, they

²⁹ See Katy Milani and Irene Tung, “Curbing Stock Buybacks: A Crucial Step to Raising Worker Pay and Reducing Inequality,” Roosevelt Institute, 2018, https://rooseveltinstitute.org/wp-content/uploads/2018/07/The-Big-Tradeoff-Report_072618.pdf.

³⁰ Lenore Palladino, “Ending Shareholder Primacy through Corporate Governance,” The Roosevelt Institute, 2019, https://rooseveltinstitute.org/wp-content/uploads/2019/02/RI_EndingShareholderPrimacy_workingpaper_201902.pdf.

³¹ Edward N. Wolff, *A Century of Wealth in America*, Cambridge, Massachusetts: Belknap Press: An Imprint of Harvard University Press, 2017.

³² *Id.* at 127.

³³ Lisa J. Dettling et al., “The Fed - Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence from the Survey of Consumer Finances,” September 27, 2017, <https://www.federalreserve.gov/econres/notes/feds-notes/recent-trends-in-wealth-holding-by-race-and-ethnicity-evidence-from-the-survey-of-consumer-finances-20170927.htm>.

³⁴ See, e.g., Jesse M. Fried and Charles C. Y. Wang, “Short-Termism and Capital Flows,” SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, November 14, 2018), <https://papers.ssrn.com/abstract=2895161>.

should logically return the cash to shareholders, who will invest the funds in companies that do have investment opportunities that are profitable to pursue. Yet net issuances in the nonfinancial corporate sector have been negative for every year since 1997, sometimes sharply so.³⁵ This means that more equity is pulled out of the market through buybacks than is created through new issuances.

There is also little evidence that there is a financing constraint for the long-term capital necessary for the development of lower-cost, higher-quality products.³⁶ Firms have large stocks of cash with which to conduct internal financing. Interest rates for corporate borrowing are historically low.³⁷ Furthermore, claims that buybacks are useful for the capital-allocation reason do not grapple with the other reasons why firms conduct buybacks: to raise the share prices and thus reward large share-sellers, and potentially executives.

History of Stock Buyback Regulation

The practice of stock buybacks at the scale we see today is a relatively recent phenomenon. For most of history, the SEC itself recognized the hazards of allowing this action and considered multiple proposals to restrict them prior to adopting its current framework.

The Securities and Exchange Act of 1934 (the “Act”) governs secondary trading of equities and lays out anti-fraud and anti-manipulation provisions to govern such activity. Prior to the adoption of Rule 10b-18, stock buybacks were subject to potential liability under several anti-fraud and manipulation statutes of the Act: Sections 9(a)(2)³⁸ and 10(b)³⁹ of the Act and its

35. Palladino, *supra* note **Error! Bookmark not defined.**. In the financial sector, new equity issuances ballooned after the financial crisis because banks issued new equity to the US government in order to be bailed out. Therefore, these new equity issuances cannot be considered along with standard issuances of equity in private markets. *See generally* Lazonick, *supra* note **Error! Bookmark not defined.**

36. *See id.*

37. *See, e.g.*, “Moody’s Seasoned Aaa Corporate Bond Yield,” FRED, Federal Reserve Bank of St. Louis, <https://fred.stlouisfed.org/series/AAA>.

38. 15 U.S.C. § 78i (2018).

39. 15 U.S.C. § 78j (2018).

promulgating Rule 10b-5.⁴⁰ Because there was no explicit permission nor denial of permission for stock buybacks, they operated in a legally hazy area, inhibiting their use. Congress passed the Williams Act Amendment to the Securities and Exchange Act in 1968,⁴¹ which focused on the tender offer process. It gave the Commission authorization to adopt rules and regulations to prohibit buybacks, by defining them as fraudulent, deceptive or manipulative, based on their role protecting investors and the interest of the public. Section (2)(e)(1) stated specifically that it is unlawful for issuers to repurchase their own securities if the purchase “is in contravention to such rules and regulations as the Commission . . . may adopt (A) to define acts and practices which are fraudulent, deceptive or manipulative and (B) to prescribe means reasonably designed to prevent such acts or practices.”⁴²

Throughout the 1970s, the Commission proposed but failed to adopt a series of rules to regulate repurchases. In 1970, Rule 13e-2 was proposed to make stock buybacks “unlawful as acts and practices which are fraudulent, deceptive or manipulative” unless the transactions were conducted according to a certain set of conditions.⁴³ The conditions included: one broker per transaction; no sales before the opening transaction and a half-hour before the close of daily trading; prices could not exceed the highest current independent bid price or the last sale price, whichever is higher; and the volume was limited to not exceeding 15 percent of the average daily trading volume in the four calendar weeks preceding the week in which the buybacks were conducted.⁴⁴ These same conditions, with the volume increased by 10 percentage points, would become the conditions for the safe harbor. The critical difference in proposed Rule 13e-2 was that all other transactions were unlawful. The proposed Rule did not include specific disclosure requirements but did include a provision under which the Commission could approve repurchases on a case-by-case basis that would otherwise be unlawful.⁴⁵

40. 17 C.F.R. 240.10b-5 (2018).

41. Williams Act, Pub. L. No. 90-439, 82 Stat. 455 (1968).

42. *Id.*

43. Purchase of Equity Securities by Issuer Thereof, 35 Fed. Reg. 11,411 (July 16, 1970).

44. *Id.*

45. *Id.* at 11412.

In 1973 and 1980, amendments to proposed Rule 13e-2 were added, including a significant proposal for disclosure. In 1973, the Commission was more forthright about its purpose for the rule, describing it as “prescrib[ing] means . . . to prevent an issuer from effecting repurchases which may have a manipulative or misleading impact on the trading market in the issuer’s securities.”⁴⁶ The Commission later described the conditions for repurchases as “designed to ensure that an issuer neither leads nor dominates the trading market in its securities.”⁴⁷ This language points to the rationale behind the types of conditions outlined, such as disallowing issuers to set the first or last price for a trading day. The Commission included an initial disclosure regime, including several questions about whether officers or directors should be required to disclose if they are considering buying or selling securities in conjunction with a repurchase that they are in charge of executing. The language points to awareness by the Commission that officers and directors face conflicts of interest, requesting comments on “[w]hether any officers or directors intend to dispose of the issuer’s securities they might presently hold.”⁴⁸ The proposal invited comments on the idea that the source of funds to be used for the repurchases should be disclosed, and how public such disclosures should be made, along with volume and manner disclosure requirements.⁴⁹

A revised proposed Rule 13e-2 also laid out the rationale for a need to limit stock buybacks. The Commission explained that the “regulatory predicate . . . [is a] need for a scheme of regulation that limits the ability of an issuer . . . to control the price of the issuer’s securities.”⁵⁰ Such a need “stems in part from the unique incentives⁵¹ that an issuer . . . [has] to control the

46. Repurchases of Securities and Prohibitions Against Certain Trading, 38 Fed. Reg. 34341 (Dec. 13, 1973).

47. *Id.*

48. *Id.* at 34342.

49. The revisions dealt with: broker-dealers who are the issuers; “block” trading; volume quotes with respect to NASDAQ, a new entity, and other minor revisions. *See id.* at 34341–42. Several additional exemptions were included because “neither situation appears to present any appreciable potential for market impact,” again demonstrating that the Commission was grappling with how to prevent the issuer from interfering in the market for its own securities. *Id.* at 34343.

50. Purchases of Certain Equity Securities by the Issuer and Others, 45 Fed. Reg. at 70890.

51. They went on to describe the incentives that face directors and officers, both as to giving an appearance of prosperity for the firm, and for insiders who may be conflicted in their own transactions. *Id.*

price of the issuer's securities."⁵² The Commission explained that the guidance was intended to help issuers avoid securities law liability that they could not otherwise predict, since the anti-fraud and anti-manipulative provisions of the Act are general in nature.⁵³ The Commission once again explained that limits it was proposing were intended to "prevent the issuer from leading or dominating the market through its repurchase program. In fashioning those limitations, the Commission has balanced the need to curb the opportunity to engage in manipulative conduct against the need to avoid excessively burdensome restrictions."⁵⁴ Again the Commission left room for a case-by-case exemption of transactions that otherwise would exceed the proposed Rule.⁵⁵

Even though the elaborate description of the need for the proposed rule was new, the substantive conditions put in place were mainly the same as in the 1970 and 1973 proposals, with one significant difference: transactions that took place outside of its conditions would not be automatically suspect.⁵⁶ The Commission gave specific reasoning as to why each of the volume, timing, pricing, and manner conditions were critical to designing procedures that would limit the impact of repurchases on the market.⁵⁷ The Commission also proposed specific disclosure requirements for large-volume repurchase programs but noted that disclosure was not a substitute for substantive regulation, explaining at some length that disclosure would not be enough to curb activity that could be manipulative to the market.⁵⁸ Disclosure would, however, "give the market an opportunity to react to the fact that the issuer may account for a substantial amount of purchasing activity in its securities."⁵⁹

52. *Id.*

53. *Id.*

54. *Id.* at 70891.

55. *Id.* at 70896.

56. *Id.*

57. *Id.* at 70898.

58. *Id.* at 70897.

59. *Id.*

In 1982, rather than proposing another revision to proposed Rule 13e-2, the Commission instead proposed Rule 10b-18, which was adopted later in the year.⁶⁰ An analysis published at the time claimed that this was a “regulatory about-face,” and that the new safe harbor should be viewed as “constructive deregulatory action . . . [that] contrasts markedly with past Commission views on the regulation of issuer repurchases.”⁶¹ Rule 10b-18 stood in contrast to proposed Rule 13e-2, which had the purposes of preventing manipulation by prohibiting the issuer from raising the market price, prohibiting the perception of wide-spread interest by the use of several broker-dealers, and limiting domination of the market with high repurchase volumes.⁶² The purpose of Rule 10b-18 instead was to facilitate repurchases and limit intrusive regulation into corporate decision-making.⁶³

Regulation of Stock Buybacks in Other Jurisdictions

Internationally, most countries with robust capital markets have some regulation in place for curbing stock buybacks, including both disclosure and substantive limitations.⁶⁴ To summarize, the significant differences from the US model of regulation include: requiring shareholder rather than board approval, placing bright-line limits on buybacks rather than adopting a safe-harbor approach, requiring immediate disclosure, and requiring insiders to not trade during buyback programs.⁶⁵ Many countries follow the US model with restrictions on timing, price, volume, and manner. Among the 10 countries with the largest capital markets, all others place clear limits on repurchase activity, and most have more specific repurchase requirements.⁶⁶ In the United Kingdom, approval is required at a shareholder meeting, not just from the board of directors.⁶⁷

60. 17 C.F.R. 240.10b-18 (2018).

61. Lloyd H. Feller & Mary Chamberlain, *Issuer Repurchases*, 17 REV. SEC. REG. 993 (1984).

62. *See id.* at 995.

63. *See id.*

64. *See* Jaemin Kim, Ralf Schremper, and Nikhil Varaiya, “Survey on Open Market Repurchase Regulations: Cross-Country Examination of the Ten Largest Stock Markets*,” *Corporate Finance Review* 9, no. 29 (2005).

65. *Id.*

66. *Id.*

67. *Id.* at 32.

Open-market share repurchases must be reported immediately to the Financial Supervisory Authority, and disclosure of volume and price is required.⁶⁸ Requirements put in place by the Tokyo Stock Exchange restrict repurchases in terms of price, quantity, and timing, and disclosure is required on execution at the close of the trading day.⁶⁹ There are also restrictions on insiders, including limiting trading of an insider's own holdings while a buyback program is underway, and mandating the establishment of trading rules to avoid conflicts of interest.⁷⁰

In European Union member states, approval at a shareholder meeting is also required, and the authorization is valid for 18 months.⁷¹ In France, significantly, the regulatory agency (the Commission des Operations de Bourse) must also approve the program.⁷² In Italy, shareholders must also approve the maximum number of shares to be acquired and the minimum and maximum purchase price.⁷³ There is a bright-line limit that a firm cannot buy back more than 10 percent of outstanding shares in France, Germany, Italy, Switzerland, and the Netherlands.⁷⁴ EU countries require repurchases to be made out of distributable profits, i.e., not purchased with debt.⁷⁵ Canada's Toronto Stock Exchange (TSE) also requires the board to seek authorization from the TSE, and repurchase activity must be filed with the TSE within 10 days after the end of each month. Repurchasing firms must also disclose whether insiders plan to sell their holdings during the firms' buyback program.⁷⁶ In Switzerland, buybacks are conducted according to a second trading line, and these transactions are fully disclosed on a real-time basis, visible to the public because the firm is the only buyer of this trading line. When a repurchase program is

68. *Id.*

69. *Id.* at 32.

70. *Id.*

71. *Id.* at 35.

72. *Id.* at 32.

73. *Id.* at 34.

74. *Id.*

75. E.U. rules stem from a 1976 EC Directive on share repurchase regulations, which specified that share repurchases should be made out of distributable profits only, not out of cash proceeds from debt issuances. *Id.* at 35.

76. *Id.* at 33.

completed, a firm must immediately make a public announcement.⁷⁷ Several countries also disallow buybacks within 10 days prior to earnings announcements.⁷⁸

Several other economies—Japan⁷⁹ and Canada, for example—have substantive bans on insider transactions during buyback program, or require disclosure of insider plans to sell their personal holdings before such a sale takes place. Other countries require immediate disclosure of buybacks, including the United Kingdom and Canada. In the UK, share repurchase decisions must be reported to the Financial Supervisory Authority immediately; and once the purchase is complete, it must be reported to the UK Listing Authority no later than 7:30 am the next business day.⁸⁰ In Canada, disclosure rules require that corporations file a notice of intention before a buyback program is undertaken; firms then have to file repurchase activity no later than 10 days after the end of each month.⁸¹

Recommendations to Rein in Stock Buybacks

At today's hearing, the Committee is considering several bills to constrain stock buybacks, and I applaud your efforts to do so.

I recommend that Congress adopt legislation that would either ban or seriously constrain the practice of open-market stock buybacks. At minimum, Congress must remove the potential for insider gain during buyback periods and require their immediate disclosure. Regardless of the direction that Congress takes, Rule 10b-18 should be repealed, as it has failed in its original intent to curb the potential harms of stock buybacks.

^{77.} *Id.* at 34.

^{78.} *Id.*

⁷⁹ Tokyo Stock Exchange Guidelines state that an insider who is in a position to make buyback decisions cannot trade his own holdings of the firm's shares while buyback program is underway.

⁸⁰ The Companies Act of 2006 and UK Listing Rules

⁸¹ By-laws of the Toronto Stock Exchange

Congress can ban open-market share repurchases by passing affirmative legislation that prohibits purchases by an issuer of its own equity on the open market. As Congress recognized in 1968 with the Williams Act, stock buybacks have the potential to allow companies to manipulate their share price. A ban is the clearest mechanism to ensure that corporate executives and share-sellers are not faced with the incentive for short-term share gain, but instead invest available resources in the types of productivity improvements that will ensure sustainable prosperity. A ban would fulfill the spirit contained within our securities laws: to ensure fairness and investor confidence in our capital markets by removing the ability of corporations to manipulate the price of their own stock.

In the alternative, Congress should limit the volume of permissible buybacks to a bright-line percentage of outstanding shares, so as to dampen both the potential for stock price manipulation and encourage the use of corporate funds for truly productive purposes. A clear limit is the best approach for ensuring compliance, accompanied by immediate disclosure of stock buybacks, restrictions on corporate insider transactions, and enforcement. The limit must be well below the 25 percent that is currently in the safe harbor. According to economist William Lazonick, with a 25 percent average daily trading volume limit, Apple could spend \$1.4 billion per day, while Exxon Mobil could spend \$200 million daily. As noted above, there is a bright-line limit that a firm cannot buy back more than 10 percent of outstanding shares in France, Germany, Italy, Switzerland, and the Netherlands.

Another alternative is for Congress to condition or prohibit the ability of a company to conduct repurchases based on other corporate variables. For example, Congress could amend the Internal Revenue Code to levy a tax of equal amount on a public company if the company does not pay a “workers’ dividend” that is commensurate with company spending on stock buybacks.⁸² Congress could prohibit buybacks if companies have unfunded pension liabilities, have engaged in layoffs, have failed to meet a certain level of productive investment, have wage

82. The Worker Dividend Act of 2018, S. 2505, 115th Cong. (2018).

dispersion below a certain threshold, or have executive compensation above a certain limit. In the alternative, Congress could condition the ability of a company to engage in buybacks only if they meet certain affirmative thresholds, based on conditions like a median worker-to-CEO compensation ratio or job creation metrics. There is the potential for different interpretations of the substantive metrics involved, and the potential for firms to take actions to try to avoid compliance requirements.

Another alternative is that Congress could use its tax-and-spend power to directly impose a specific tax on stock buyback transactions by amending the Internal Revenue Code, regardless of other corporate behavior. Taxation would disincentivize firms to conduct stock buybacks. Though it is extremely difficult to estimate the elasticities of trading volume with respect to financial transaction taxes generally, it is likely that a tax on repurchases would serve to significantly reduce their use, if the tax was set higher than capital gains taxes.⁸³

Finally, specific policy reforms must focus on addressing the particular potential for corporate insiders to personally gain during buyback announcement and execution periods. First, corporate insiders—both executives and directors—should be prohibited from selling their personal shares in the aftermath of a buyback announcement and execution. Second, at minimum, buyback execution programs should be immediately disclosed, rather than allowing corporations to wait until their next quarterly filing to announce buyback activity. Activity should be disclosed at the daily level, rather than monthly.

Conclusion

83. For the relevant literature on financial transaction taxes and their effect on stock trading volume, see generally Robert Pollin, James Heintz, and Thomas Herndon, “The Revenue Potential of a Financial Transaction Tax for U.S. Financial Markets,” *Political Economy Research Institute*, Working Paper Series Number 414, July 2017, <https://www.peri.umass.edu/publication/item/698-the-revenue-potential-of-a-financial-transaction-tax-for-u-s-financial-markets>. For additional analysis on the effects of a stock buybacks transaction tax, unpublished research is on file with the author.

In conclusion, the current use of stock buybacks poses a threat to a productive and equitable economy, and I applaud the committee for taking a hard look at this practice. The SEC's Rule 10b-18 has both substantive and democratic flaws in its implementation, and it is not an effective mechanism to appropriately curb issuer repurchasing behavior. Congress should adopt a new statute to ban repurchases as impermissible, or, in the alternative, place bright-line limits on corporate use of open-market share repurchases. At minimum, Congress should immediately remove the ability of corporate insiders to personally benefit from buybacks and require their immediate disclosure. In order to ensure that capital markets are not manipulated by tremendous repurchase activity or the interests of a small group of executives and share-sellers, new policies to rein in stock buybacks are required.