EXAMINING CORPORATE PRIORITIES: THE IMPACT OF STOCK BUYBACKS ON WORKERS, COMMUNITIES, AND INVESTORS

HEARING

BEFORE THE

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EXAMINING CORPORATE PRIORITIES: THE IMPACT OF STOCK BUYBACKS ON WORKERS, COMMUNITIES, AND INVESTORS

Thursday, October 17, 2019

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Carolyn B. Maloney, [chairwoman of the subcommittee] presiding.

Members present: Representatives Maloney, Scott, Foster, Vargas, Gottheimer, Gonzalez of Texas, Porter, Axne, Casten; Huizenga, Hill, Emmer, Mooney, Davidson, and Hollingsworth.

Ex officio present: Representatives Waters and McHenry.

Also present: Representatives Green and Garcia of Illinois.

Chairwoman MALONEY. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

Today's hearing is entitled, "Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors."

I now recognize myself for 5 minutes to give an opening statement.

This hearing will examine the use of stock buybacks, which has grown dramatically over the past 2 decades, and has grown especially quickly in the past 2 years. When companies have excess cash on hand, they face a choice about what to do with the money. They can use it to invest in research and development, purchase new equipment, raise their employees' wages, or they can pay their own shareholders.

Now, I want to be clear. I have nothing against companies returning capital to their shareholders. Shareholders invest their money in promising companies, and if those companies are successful, then shareholders deserve a return on their investment. But how companies return capital to their shareholders is what we are going to discuss today.

Companies essentially have two options to do this: they can pay a cash dividend to all shareholders; or they can buy back stock from any shareholder willing to sell their stock back to the company.

Prior to 1982, public companies very rarely engaged in stock buybacks because the legality of buybacks was questionable. When a company buys back its own stock, it temporarily drives up the price of its stock, which could be considered a form of illegal market manipulation, so companies primarily return capital to shareholders by paying dividends.

Then, in 1982, the SEC adopted a rule that gave companies a safe harbor when they engaged in stock buybacks. Ever since the SEC adopted that rule, companies have used stock buybacks more and more, and have used dividends less.

There are a number of reasons why companies prefer buybacks to dividends. One reason is that buybacks are slightly more tax-efficient than dividends. But the most important reason, I believe, is that executives at public companies have a personal incentive to favor buybacks over dividends. Because executives are often compensated in company stock, executives can use a buyback program to boost the company's stock price right before selling their own stock at these artificially inflated prices.

In fact, a study by SEC Commissioner Robert Jackson found that executives at public companies sold up to 5 times more stock than usual immediately following a buyback announcement, which strongly suggests that executives have been abusing stock buybacks for personal gain. In addition, if a company is in danger of missing its earnings-per-share target, then the executives can simply announce a stock buyback program to temporarily boost the company's earnings per share and hit their target.

Unfortunately, the use of buybacks has grown significantly in the past 2 years due almost entirely to the 2017 tax bill. Even though many large companies claimed that they would use their tax cuts to reinvest in their businesses or raise their employees' wages, in reality companies spent roughly 40 to 60 percent of their tax breaks on stock buybacks.

Companies in the S&P 500 spent roughly $811 billion on buybacks in 2018, which was a 50-percent increase from 2017, and buybacks are on pace to increase even more in 2019 to nearly $1 trillion. With this surge in stock buybacks, I think this hearing is very timely, and we will be examining several pieces of legislation on stock buybacks in this hearing.

First, we have a bill by Mr. Garcia called the Reward Work Act, which would prohibit companies from engaging in open market stock buybacks. The bill would also require at least one-third of the directors at public companies to be elected by ordinary workers in order to give them a stronger voice in how the company is run.

Second, we have the Stock Buyback Reform and Worker Dividend Act, which is the companion to a bill that Senator Sherrod Brown, the ranking member of the Senate Banking Committee, has introduced in the Senate. This bill would require public companies that engage in stock buybacks to also reward their workers by issuing a so-called worker dividend every time they engage in stock buybacks. For every $1 million the company spends on buybacks, they would have to issue a special $1 dividend to all of their ordinary workers, too.

Third, we have a bill that would require increased disclosures for companies engaging in stock buybacks and would also require SEC approval for the buybacks.

Lastly, we have a bill that would require companies to make disclosures about executives' participation in stock buyback programs and how the buybacks will affect executive compensation.

I look forward to hearing from all of our witnesses on this important topic.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 5 minutes for an opening statement. Thank you.

Mr. HUIZENGA. Thanks, Madam Chairwoman, and I look forward to having this discussion regarding these stock buybacks and the impact on workers, communities, and Main Street investors.

Recently, as you are hearing, the practice of stock buybacks has attracted some scrutiny from some on Capitol Hill. In fact, this scrutiny seems to be based on a bit of a myth, so I believe we should first start with the facts on what a stock buyback really is, and we can just call that, "Stock Buyback 101."

When a private company goes public, it has an initial public offering, through which a company divides itself into shares that can be sold to investors. Thus, the members of the public can invest in this company and become shareholders. Shareholders earn regular dividends based on the company's performance, which are generally the incentive for an investor to purchase a company's stock.

Shareholders are free to buy and sell shares, thus earning money when they sell their shares, based on the price at which they initially bought the shares. After the initial public offering (IPO), the company, or the issuer, can then opt to issue more shares called share dilution. When the company issues more shares, the value of each share decreases because each share represents a smaller percentage of the company.

Alternatively, a company may repurchase shares of its own stock, thus reabsorbing that portion of its company and reducing the number of shares on the market, increasing the value of each stock and each share. That is just basic economics. This is commonly referred to as a stock buyback or stock repurchase.

Companies use stock buybacks to make shares available for dividend reinvestment, stock options, employee stock ownership plans, to provide liquidity in the marketplace, and, many times, as a preferred and efficient way of returning capital to shareholders.

Stock buybacks are important to businesses and the economy because: one, they provide managers with a tax-efficient means of returning excess capital to shareholders; and two, they allow managers to signal to investors that the firm is undervalued when strong.

Returning excess capital is value-adding for two reasons: first, it helps prevent companies from pursuing growth in size at the expense of profitability and value; and second, by returning capital to investors, repurchases, like dividends, play the critically important economic function of allowing investors to channel their investment from mature or declining sectors of the economy to more promising ones.

In 1982, to address concerns over market and price manipulation by issuers, the SEC adopted Rule 10b-18, which created a safe harbor from liability for market manipulation for companies engaged in stock buybacks. However, issuers must adhere to limitations on manner, timing, price, and volume conditions that are intended to minimize the impact that buybacks have on the company stock price. That was the speed bump that was put in place by the SEC.

Additionally, public companies are required to disclose any purchases of their own stock in their quarterly and annual reports, providing a table showing month-by-month statistics, including the number of shares purchased, the average price per share paid, the total number of shares purchased under the repurchase program, and the maximum number of shares or maximum dollar amount the company can repurchase under its publicly announced programs. Again, publicly announced programs, so this should not be a mystery or somehow be hidden from anybody.

Essentially, a stock buyback program is just another way, like dividends, that a publicly traded company can return money to their shareholders. Although dividends provide shareholders with the ability to remain invested in a company while receiving a regular income stream, a business may instead prefer stock buybacks over dividends because of tax considerations, but also because it promotes a more efficient allocation of capital by redistributing excess cash to more productive uses.

While some continue to create strongman arguments about stock buybacks because they believe it feeds into their political narrative, the fact remains that stock buybacks are just another tool used by companies and managers to promote economic opportunity for their employees, while providing sufficient benefits for American workers and Main Street investors, like "John and Jane 401(k)." In fact, stock buybacks lead to an increase in the value of their retirement portfolios, 401(k) plans, pension funds, and college savings accounts. How is that a bad thing?

The proposals that we are considering today will do more harm than good by encouraging more companies to choose to stay private and shy away from the public market. We have had extensive conversations about that. Instead, let's work together on proposals that will promote more capital formation and economic opportunity, that give these mom-and-pop investors more choices and increases their ability to grow their savings and retirement accounts.

With that, I yield back.

Chairwoman MALONEY. Thank you.

Today, we welcome the testimony of a distinguished panel of witnesses.

First, we have Jesse Fried, who is a professor of law at Harvard Law School.

Second, we have Lenore Palladino, who is a senior economist and policy counsel at the Roosevelt Institute, which is located in my district in Manhattan.

Third, we have Janie Grice, who is a leader at United for Respect at Walmart.

Fourth, we have Derik Coffey, who is a portfolio specialist at Channing Capital Management in Chicago.

And last, but not least, we have Craig Lewis, who is the Madison S. Wiggington Professor of Finance and a professor of law at Vanderbilt University.

Witnesses are reminded that your oral testimony will be limited to 5 minutes, and without objection, your written statements will be made a part of the record.

Professor Fried, you are now recognized for 5 minutes to give an oral presentation of your testimony.

STATEMENT OF JESSE M. FRIED, PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. FRIED. Chairwoman Maloney, Ranking Member Huizenga, members of the subcommittee, thank you for inviting me to testify. I am honored to be here.

In my 5 minutes of remarks, I will discuss the overall level of dividends and repurchases by public firms and explain why it is unlikely to be too high; it might, in fact, be too low; explain how the current disclosure rules around share buybacks are too lax and enable executives to enrich themselves at the expense of public investors; and suggest how such abuses could be limited by a simple fix, which is requiring corporations to disclose trades in their own shares within 2 days, just like corporate insiders are required to disclose their own trades. I am happy to share my views on the bills under consideration in the discussion that will follow.

Let me begin by addressing the aggregate level of payouts by public companies. U.S. public companies distribute in cash about $1 trillion a year. About 40 percent takes the form of dividends, and 60 percent takes the form of repurchases. But this is important. Dividends and repurchases do not actually reflect actual cash flows between shareholders and public companies. Public companies issue huge amounts of stock, and those issuances absorb cash from shareholders and put it back, directly or indirectly, into companies.

The way to think about capital flows between firms and public shareholders is to look at net shareholder payouts, which is dividends, plus repurchases, minus equity issuances. For example, in 2018, U.S. public companies distributed about $1.4 trillion in cash through dividends and repurchases, but they simultaneously issued about $750 billion in equity. So, the net shareholder payouts to public investors was about $650 billion.

Now, $650 billion sounds like a lot of money, but it is only a portion of the profits that these firms have generated. My research with Professor Charles Wang at Harvard Business School indicates that there is no reason to think that firms are distributing too much cash. Investment measured as capital expenditures, plus research and development expenses, are at an all-time record.

You might say, maybe they would be even higher if firms had more cash, but firms have been accumulating $5 trillion of cash through 2018, even though they have been making record payouts and spending record amounts on investment.

There might be individual public firms that do not have a lot of cash, but those firms can simply issue more stock in the public markets. That is one of the reasons why firms go public, so they can easily finance themselves. And, in fact, Charles Wang and I have found that if you look at the smallest public companies, they are routinely absorbing more capital from public investors than they are distributing capital through dividends and repurchases.

Another thing to remember, and this echoes what Representative Huizenga said, is that the capital that flows out of these companies is not wasted. It is available for investment in private companies, which are smaller, faster growing, and absorb hundreds of billions of dollars of capital each year.

Everybody is focused on public companies because they are big and they disclose information to investors in the public, so we see them. But companies that are not traded are just as important a part of the economy. They account for about half of the fixed investment in the economy, and they employ 70 percent of the workforce, of the non-government workforce. Capital that flows out of public firms can flow into private firms. So, there is $5 trillion sitting in these companies, and it is unlikely that that money is better left there than being distributed.

So, while the overall level of distributions is probably not too high, there are problems with the use of repurchases to distribute cash. The first is that they can be used for indirect insider trading. Executives who own stock in the company can profit by having the company buy stock at a low price. This can systematically transfer value to insiders. I have estimated that the value transfer is on the order of several billion dollars a year. In addition, companies can use buybacks to prop up the stock price as executives are selling, and this can help executives sell their shares at a higher price.

Both of these abuses are facilitated because of the disclosure rules—

Chairwoman MALONEY. Time has expired, so please wrap up quickly.

Mr. FRIED. Okay. Basically, the disclosure rules around repurchases are very lax. You have to disclose trades, but not individually, and after a couple of months. If you require firms to disclose their trades immediately, or within 2 days and in detail, you would be able to curb a lot of these abuses.

[The prepared statement of Mr. Fried can be found on page 35 of the appendix.]

Chairwoman MALONEY. Thank you very much.

Ms. Palladino, you are now recognized for 5 minutes for your testimony.

STATEMENT OF LENORE PALLADINO, SENIOR ECONOMIST AND POLICY COUNSEL, ROOSEVELT INSTITUTE

Ms. PALLADINO. Thank you, Chairwoman Maloney and Ranking Member Huizenga, for inviting me to speak today. It is an honor to be here.

I join you today to discuss the causes and consequences of stock buybacks. Stock buybacks may sound like a technical matter of corporate finance. Why does it matter whether or not corporations repurchase their own stock?

When a company executes a stock buyback, they prop up their share price for the benefit of share sellers, but the funds spent on buybacks are then unavailable for the types of corporate activities that could make the company more productive over the long term, investments in future productivity, and in workers.

Stock buybacks are virtually unregulated. Even though Congress has recognized their potential for market manipulations, and companies are spending billions of dollars a year, stock buybacks have reached record volume. Corporations spent roughly $900 billion on them in 2018, and projections for 2019 are even higher. The volume of stock buybacks explains why more money has flowed out of our public capital markets than has flowed back in for the non-financial sector for years.

Let me explain why stock buybacks are virtually unregulated. SEC Rule 10b-18, the stock buyback safe harbor, gives companies the go-ahead to spend up to 25 percent of their trading volume on buybacks without liability for market manipulation, but also states that there is no presumption 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 daily safe harbor limit.

Importantly, there are 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 if 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 executing buybacks. This is why there is an urgent need for new policies.

Congress and the SEC recognized decades ago that this kind of practice could manipulate the market. Rule 10b-18 was a sharp departure from the proposals made by the SEC in the 1970s that clearly recognized that the large volume of stock buybacks could have a manipulative effect.

Companies are conducting stock buybacks in the midst of layoffs, calls by their workforce for an end to poverty wages, and clear, alternate uses for corporate funds. Let me give a few examples.

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, yet the company reportedly avoided spending the estimated $7 billion it would have needed to engineer a safer plane.

Less than 10 years after a public bailout, GM has spent $10.6 billion on stock buybacks while engaging in layoffs and plant closures. That amounts to roughly $220,000 for each GM worker who has been on strike.

Walmart spent $9.2 billion on stock buybacks in the last year, which could have been used to give a raise of roughly $5 an hour to each of its one million hourly workers.

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 funds. This requires companies to issue new shares rather than for shares to simply trade on the secondary markets, yet we have seen fewer shares issued than shares repurchased for years.

This also begs the question, could it really be the case that so few American corporations have innovative ideas, could pay down debt, or invest in their workforce? I argue there is another motivation for the high volume of stock buybacks: propping up stock prices for the benefit of short-term share sellers, which can include corporate executives.

I recommend that Congress ban stock buybacks, or in the alternative, place low bright-line limits on their use. A ban is the clearest mechanism 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 and remove the safe harbor so as to dampen both the potential for stock price manipulation and encourage the use of corporate funds for productive purposes.

At a minimum, policy reforms must prohibit corporate insiders from selling their personal shares in the aftermath of a buyback before it is disclosed, and any buyback program should be immediately disclosed.

I applaud the committee for taking a hard look at stock buybacks, and I look forward to your questions. Thank you.

[The prepared statement of Ms. Palladino can be found on page 67 of the appendix.]

Chairwoman MALONEY. Thank you very much.

Ms. Grice, you are now recognized for 5 minutes for your testimony.

STATEMENT OF JANIE GRICE, UNITED FOR RESPECT AT WALMART

Ms. GRICE. Thank you, Chairwoman Maloney and Chairwoman Waters, for inviting me here to speak today. I am honored to be here.

My name is Janie Grice, and I am from Marion, South Carolina. I worked at Walmart as a cashier and later as a customer service manager while I was raising my son as a single mother. I am here today as a leader with United for Respect to speak on behalf of the 1.4 million associates who work for Walmart.

Most of you do not know Marion, South Carolina. We are a small town in the American south that many have forgotten. When our first Walmart came to town, everyone was so excited. We had lost so many jobs when manufacturing factories shut down and moved overseas. Finally, we had jobs that paid well and where management treated you well.

Then, our little Walmart became a supercenter, and everything changed. All of a sudden, there were half as many available hours but twice as much work for each associate. I had been trying to work at Walmart for years because people said it was a good company to work for, and I was promised full-time hours. So, I started out as a cashier, working for $7.78 an hour. In my 4 years there, I never got to full-time employment or a stable schedule.

Do you know how hard it is to spend time with your family or pay your bills when you have no clue how many hours of work you are going to get or when you are going to work? I always had to choose my job at Walmart over time with my son, because without me working, we could not have had the things that we had.

I want my son and grandson to have a better future, so I left to find something else, even though I love my Walmart family. That is why I was so mad when I read about the $20 billion in buybacks from Walmart that made the executives and Walton heirs even richer. I don't mind investors making profits. I do mind when associates, like me, who have been putting the work in day after day, year after year, do not get to share in those profits.

This is exactly why I filed a shareholder proposal at Walmart last year that will reward associates for our dedication and commitment to the company by getting a share of the profits from buybacks. Shockingly, my proposal did not pass, but it started a real conversation about how corporations, like Walmart, need to make different choices instead of squeezing workers.

Lenore Palladino's research shows that $10 billion in buybacks that Walmart authorized could have been used to give a million associates a $5 hourly wage increase. If I sat on Walmart's board of directors, I would not think twice about approving that decision. Can you imagine how much turnover we could reduce or how many part-time associates could get off of public benefits? It is so painful to think that this could have been a reality, but a small group of people at the top decided not to prioritize associates like me.

This is not just happening in retail, but also in other industries. At Wells Fargo, one-third of their workers make $15 an hour, while the bank has authorized over $40 billion in buybacks since the 2017 tax bill.

At AT&T, the hedge fund, Elliott Management, is trying to strip down the company and use that money for buybacks, money that could be used to bring internet access to workers and businesses.

What these companies are doing with buybacks is both wrong and harmful to the majority of us, and we don't get a say in any of it. Think about what corporate America would look like if workers at Walmart, Wells Fargo, AT&T, Sears, and other companies actually had a seat at the table. We would invest the corporate profits back into the company, the workers, and the investors.

This is what my fellow United for Respect leader Cat Davis was saying when she filed a shareholder proposal at Walmart this year to have hourly associates on the company's board. Her proposal makes the case that having hourly workers on the board could lead to long-term profitability for all of us.

Right now, Walmart is paying so low that a full-time associate earning a starting wage still falls below the Federal poverty line for a family of three. How shameful is that, that we have to live in poverty while working for the largest private employer in the world, which has billionaire owners who are worth $175 billion?

So, what this committee is doing on regulating buybacks is really important. I am here to ask you to seriously consider who you stand with: working people like me, who work hard and reap little rewards; or corporate billionaires, who will exploit every loophole to get richer. By regulating how corporate profits are spent and who benefits from them, you are putting workers first and letting corporate America know that we matter.

You are saying that if a company can issue billions in buybacks, it can afford a living wage and full-time employment for its workers.

You are saying that it is time to end economic inequality in the U.S. so that working mothers, like me, can save for a better future for our kids.

These days, we have to work two or three jobs to make ends meet. We catch hell with all of the expenses and taxes we have to pay. We do not have billion-dollar inheritances to fall back on like the Waltons do, but we have the power of our voices to call out corporations like Walmart for doing wrong by us.

Buybacks are a rigged game. They are not good for workers or for American companies. We need bold, decisive action from all of you to rein in corporate America and level the playing field. Working people like me deserve a better shot at fairness and equality. Thank you.

[The prepared statement of Ms. Grice can be found on page 50 of the appendix.]

Chairwoman MALONEY. Thank you very much.

Mr. Coffey, you are now recognized for 5 minutes for your testimony.

STATEMENT OF DERIK D. COFFEY, CFA, PORTFOLIO SPECIALIST, CHANNING CAPITAL MANAGEMENT

Mr. COFFEY. Thank you, Chairwoman Maloney. By way of background, Channing Capital Management is a Chicago-based investment management firm serving institutional investors, that was founded in 2003. We currently have over $2 billion in assets under management, and a diversely owned firm, with the majority of our equity held by African Americans. We focus on small, midcap products with domestic and international exposure. It is worth noting that while we have a diverse client base, a large portion of our clientele consists of defined pension benefit plans, many of whom are union workers, policemen, firefighters, teachers, and city and State municipal workers, all whom also benefit from stock buybacks.

Let me quickly just outline what are stock buybacks and why companies use them. When discussing capital allocation strategies such as dividends or stock buybacks, the old maxim, "a bird in the hand is worth two in the bush," is often quoted. In short, investors view the certain up-front cash as less risky and generally prefer the assurance of receiving some cash in hand, which gives them options to decide when, where, and how to deploy cash received to generate a higher return.

When capital exceeds a company's expenditure needs, returning this capital to shareholders is considered a prudent strategy that empowers investors to redeploy excess cash to areas where they can find better growth opportunities. In short, buybacks help companies to manage a capital structure; they provide more flexibility relative to dividends for capital allocation or capital return; they offset dilution from employee stock options; and they provide important share price signaling that is important, particularly in cases where the market has a more pessimistic view of a company relative to actually the company's internal management.

Let me discuss how buybacks benefit our clients. As I read earlier, a large number of our clients are defined benefit pension plans, but we also have a decent and growing exposure to endowments, foundations, wealth management firms, and corporate plans. The common thread across all of these clients, including people who invest in 529s because they are saving for college plans for their children, and just regular investors who are saving for retirement, is that they all benefit from buybacks.

Buybacks encourage better alignment of management with shareholders, addressing the agent-principal issue. When managers of a company actually own the shares, they can act more in the interest of the long-term shareholder value.

Buybacks help boost share price, which again helps our clients.

Buybacks provide tax benefits, being that they are taxed at the capital gains rate, whereas non-qualified dividends are taxed at the ordinary income rate.

Buybacks offer investor choice. For investors who are looking for an opportunity to deploy capital to higher returns, buybacks provide that liquidity to go and find that opportunity.

With that said, there are definitely instances where buybacks do warrant greater scrutiny or could potentially be harmful to investors. Buybacks that are exclusively used to achieve short-sighted goals via financial engineering are especially harmful.

A second example are instances where a company has a long history of share repurchases but continues to lose shareholder value despite these efforts. We, at Channing, have very little patience for management teams that use buybacks or other means to engage in short-sighted financial engineering schemes. Good companies, in our view, productively utilize their capital to hire employees, invest in their businesses, and expand their market share. And companies that do not do these things do not deliver shareholder value, and their shares are sold.

Let me briefly address why buybacks have surged over the past several years, and there really are two reasons: the extended duration of the bull market that started in 2009; and the tax reform legislation that has encouraged more repatriation of overseas profits.

It is no surprise that buybacks have surged across large and small capitalization stocks since the beginning of the current economic crisis. Typically, buybacks increase during periods of economic expansion, and they are less robust in periods of economic contraction. And, so, when we take a look at buybacks, it really reflects the fact that repatriation creates an opportunity to bring a lot of excess cash from overseas into the United States. More importantly, this is most prominent amongst large cap companies, particularly companies in the technology sector.

Small capitalization companies did not have as much cash overseas, and so this issue was exacerbated, particularly among companies that are large cap companies that have a lot of overseas cash held overseas. And it is also the long duration of the bull market.

With that said, let me talk a little about the risk of increased restrictions on buybacks. Any proposed legislation that is designed to stymie or retard buyback activity could result in negative consequences for investors, the economy, and the optimum allocation of capital. The key question one should ask is whether it is better to legislate an issue that is cyclical, or one that reflects a structural imbalance. I would argue that the recent buyback activity is much more cyclical in nature.

Allow me to outline some of the potential pitfalls of legislation that could potentially curtail buybacks.

Restrictions could trap capital in businesses, leading to inefficient allocation of capital; they could impede the movement of capital to future growth opportunities; they could force businesses to use inefficient means to distribute cash to shareholders; and ultimately, another consequence is the restriction on buybacks, you lose the powerful signaling tool.

In conclusion, I would like to thank the subcommittee for inviting me to address this important topic, and I am open to any questions. Thank you.

[The prepared statement of Mr. Coffey can be found on page 28 of the appendix.]

Chairwoman MALONEY. Professor Lewis, you are now recognized for 5 minutes for your testimony.

STATEMENT OF CRAIG M. LEWIS, MADISON S. WIGGINGTON PROFESSOR OF FINANCE AND PROFESSOR OF LAW, VANDERBILT UNIVERSITY

Mr. LEWIS. Chairwoman Maloney, Ranking Member Huizenga, and members of the subcommittee, thank you for inviting me to appear today to discuss corporate priorities as they relate to share repurchase programs, workers, communities, and investment.

The House Financial Services Committee is considering a number of regulatory initiatives designed to reduce or even eliminate the ability of corporations to repurchase shares. In my written testimony, I discuss the economic substance of share repurchase programs, or stock buybacks, and argue that they represent a highly efficient way to distribute excess cash to shareholders.

There are four House bills under consideration: the Reward Work Act; the Stock Buyback Reform and Worker Dividend Act of 2019; the Stock Buyback Disclosure Improvement Act of 2019; and a fourth stock buyback disclosure bill. All of these bills reflect an implicit perspective that share repurchase programs represent a market failure that cannot be resolved through private action.

Opponents of share buyback programs typically argue that they artificially inflate share price, crowd out investment, result from managerial short-termism, and disproportionately benefit the wealthy and corporate insiders. I argue in my written testimony that these conjectures are either not supported by empirical analysis or are based on misconceptions about how share repurchase programs actually operate.

Although similar to ordinary dividends, share repurchases differ in several important ways. The most compelling examples include: their ability to signal undervalued share price; their role as a mechanism for distributing excess cash; individual income tax advantages; and reallocation effects. This last point is particularly important because the cash paid to shareholders does not disappear. The reallocation of excess cash into consumption and other investments potentially redirects it to activities that have a higher value than the incremental investments that are available to firms.

These examples contrast sharply with critics who view stock buybacks as nothing more than financial gimmicks that crowd out investment and artificially inflate share price. Although I will be happy to discuss this in detail should you have questions, I would, however, like to emphasize that the empirical evidence is inconsistent with the notion that stock buybacks in some way constrain investment in the future.

With respect to the bills that are the topic of today's hearing, allow me to first discuss the two bills that are designed to reduce the ability of corporations to repurchase shares: the Reward Work Act; and the Stock Buyback Reform and Worker Dividend Act of 2019. The Reward Work Act calls for the outright prohibition of share repurchase programs. The second bill would require firms that repurchase shares to pay workers an amount proportional to the amount spent on buybacks.

Both bills are based on the premise that if share repurchase programs are curtailed or become more expensive, firms will elect to increase investment in tangible and intangible assets, like R&D, and pay workers more. If regulation creates incentives for firms to reinvest rather than distribute excess cash, it would likely lead to an over-investment problem in which firms would make inferior investments that would be unlikely to benefit the economy in the long run.

The second set of bills, namely the Stock Buyback Disclosure Improvement Act of 2019, and a second stock buyback disclosure bill, are designed to increase transparency around share repurchase programs. The first of these bills is largely a response to SEC Commissioner Robert Jackson's views regarding executive participation in share repurchase programs. For reasons I discuss in my testimony, I believe that the underlying research that informs these concerns fails to document a significant market failure.

The second bill seeks to increase mandatory disclosure about the nature and purpose of planned share repurchase programs. This bill includes the requirement that firms must pre-announce a repurchase program 15 days prior to its execution. Since repurchase programs are typically executed over relatively long periods of time, it is unclear how, in the context of the existing empirical evidence, mandatory pre-announcement is preferable to the existing 8-K and insider trading disclosure requirements and 10-Q filings.

The most surprising aspect of this bill is that the SEC would be required to approve buyback programs before they can be implemented. The decision to require a disclosure-based regulator like the SEC to become involved in financial decisions is unprecedented. Not only does the SEC lack the expertise to make such determinations; it is unclear how this serves the Commission's tripartite mission of investor protection, the maintenance of fair and orderly, and efficient markets, and the facilitation of capital formation. Thank you very much.

[The prepared statement of Mr. Lewis can be found on page 54 of the appendix.]

Chairwoman MALONEY. Thank you. I now recognize myself for 5 minutes for questions.

Ms. Palladino, you mentioned in your testimony that stock buybacks are a driver of income and wealth inequality. Can you talk a little bit more about how buybacks are contributing to increased inequality?

Ms. PALLADINO. Yes. Thank you for the question.

It is important to recall that gains from share selling flow disproportionately to a small group of wealthy households, and I will give you a few numbers from the Federal Reserve's distributional financial accounts.

As of the second quarter of 2019, the top 1 percent of the wealth distribution owns 52 percent of corporate equities, while the bottom 50 percent owns just 2.2 percent. In other words, the gains flow disproportionately to those in the very top of the wealth distribution. It is also important to note that 92 percent of corporate equities are held by white households. So, when we look at the combined effects of income and wealth, we can see the disproportionate flow to the top.

Chairwoman MALONEY. Okay. Thank you.

Ms. Grice, you mentioned in your testimony that you think it is a very good idea for large companies to have ordinary workers represented on their boards. Can you talk a little bit about the benefits of having worker representation on corporate boards, and what sort of perspective would the worker representative bring to the boards that current board members do not have?

Ms. GRICE. Thank you, Chairwoman Maloney, for that question. Hourly associates are the closest one to the problems at the company, so we are also closest to the solutions. For us to have a voice at the top means that we could tell the executives what the other associates and consumers think and how to solve these issues immediately, instead of waiting years.

Take family leave policies, for example. We have that at Walmart, because we fought for it. We told the home office that this is what associates need, and they just ignored us. Imagine how much they could have saved on turnover if they listened to us sooner. This could have been a real partnership where we have the power to guide in better, more humane decisions.

Chairwoman MALONEY. Thank you. Thank you so much.

Mr. Coffey, you talked about how, as an investor, you have to distinguish between buyback programs that are beneficial and those that are being used for short-term financial engineering. How do you distinguish between these two types of buybacks?

Mr. COFFEY. At Channing, one of the things we do is we look at our companies, we talk to management teams regularly, and we have financial models. We can see very clearly when a company is using buybacks to typically, when they are using these tools, they use it to shrink their shares outstanding, and that increases their return on equity.

We have models that can tell us very clearly what a company's real return on equity is when you sort of adjust for stock buybacks. And, so, any sort of financial engineering that does not increase the long-term value of the company, which is sort of how we look at long-term intrinsic value of the company. And if actions are not necessarily increasing that, but they are increasing the short-term metrics, we can call them out. And we can also see that when we look at proxy statements with compensation. We can see whether those goals are short-sighted and they are motivating management to move to short-term goals. So, our models allow us to see that.

Chairwoman MALONEY. Professor Fried, you mentioned in your testimony that other countries have rules similar to the 2-day disclosure rules that you are proposing: Japan, Hong Kong, and the U.K. already have similar disclosure rules. What were the effects in these countries when they implemented those rules? Did stock buybacks decline? Did executives' trading behavior change? What happened?

Mr. LEWIS. I have not studied what happens in terms of the implementation of these rules in these other countries. Generally, the level of buybacks in the U.K., Hong Kong, and Japan is much lower than in the United States. The point is that it is possible to require companies to disclose this information within 2 days. Other countries have figured out how to do this, so there is no reason that we cannot do it.

Chairwoman MALONEY. What has been the effect on capital markets, if at all?

Mr. LEWIS. I do not know if there has been a study that looks at the effect of the imposition of these disclosure rules in these other countries. As far as I know, these disclosure rules have been used in these countries for decades, so I do not think it was something that was recently done that would allow like an econometric test to see what the effect was.

Chairwoman MALONEY. Thank you. I yield back, and I now recognize the distinguished ranking member for 5 minutes for questions.

Mr. HUIZENGA. Thank you, Madam Chairwoman.

Mr. Coffey, I want to start with you. I love the term, the "financial engineering decisions," and I am curious, you were talking about how you have models that identify those people or those entities. What percentage of companies that you invest in would you say have some sort of short-term, short-sighted, harmful financial engineering decisions versus longer term?

Mr. COFFEY. I would say, given that we have a long holding period for our companies, our turnover is about 30 percent. We hold our companies in 3- to 5-year periods, and it is trying to buy high-quality companies with free cash flow and long-term objectives. I would say essentially less than 1 percent. It is a long-term focus. And management teams that shift their focus to short-sighted objectives are removed from our portfolio.

Mr. HUIZENGA. That was going to be one of my questions, how do you deal with that? You identify them and you remove them from your portfolio and no longer invest in them?

Mr. COFFEY. That is correct.

Mr. HUIZENGA. Okay. And this is one of my general questions as we are talking about this. Whether it has been repatriation that you brought up, whether it has been a booming economy that has brought in additional cash to companies and their workers and others, what are these entities supposed to do with this additional cash? At some point, if you have the equipment that you need; if you have the right number of employees that you need; and you have increased wages, which we have seen statistically have gone up; you have done bonuses; you have done all of these things. What else are you supposed to do with this cash?

And Mr. Lewis? Mr. Fried? I'm curious. Mr. Coffey? What else should they do with this? Because it seems like you are suddenly into a question of reallocation and maybe a misallocation of those resources.

Mr. COFFEY. I will start. As you have already mentioned, when a company exhausts all their sort of means of deploying capital—they have invested in plant equipment, they have done research and development, they have invested in human capital, and they have also considered mergers and acquisitions to gain market share in a particular industry—the best thing to do is to find a way to distribute that capital, because it introduces opportunities for a business to actually destroy shareholder value. You can make an acquisition, or you can overpay for an acquisition, or you could engage in activity that is just not lucrative to shareholders.

Basically, you think about the term, "capital osmosis." When you have excess capital after you have kind of exhausted your needs, that capital should be recycled to other growth opportunities so you can get the future companies that we think about today that are going to drive shareholder value in the future.

Mr. HUIZENGA. Mr. Lewis, how does a healthy stock market benefit seniors and the middle class?

Mr. LEWIS. I think Mr. Coffey talked about how a lot of his clients participate in defined benefit pension plans. And, so, the way that stock buybacks benefit investors is that companies announce stock buybacks when they believe their firm's stock price is undervalued. And it turns out that that is a credible signal.

Investors interpret stock buybacks as a credible signal, largely because management owns significant equity stakes in the company, and they would be reluctant to overpay for shares in a stock buyback program when they are directly subsidizing the shareholders that sell. So, it benefits seniors. It benefits retirees to the extent that stock prices go up, and the value of their portfolios increases.

Mr. HUIZENGA. And do additional regulations help achieve economic growth?

Mr. LEWIS. In this case—I was a Chief Economist at the SEC, and one of the important factors for basically promulgating or proposing any rule is to demonstrate that there is a market failure that cannot be resolved through private action. And, so, in this case, it is unclear to me what the market failure actually is.

Mr. HUIZENGA. Okay. I only have a few seconds left.

Professor Fried, you had a post on a Harvard Law School Forum on corporate governance and financial regulations which stated that some of these bills that would prohibit buybacks are based on a "profound misunderstanding of how the U.S. economy works." I am curious if you could explain what that means; and then, do you believe that, or do you agree with some of the thinking that cash on the balance sheet would either go to buybacks or directly to workers?

Mr. FRIED. Thank you for that question. I think there are a lot of misconceptions in the conversation around buybacks. The first is that we do not have good ways of thinking about how to measure them. That is why you have to look at equity issuances. If you look at like net repurchases, which are repurchases minus equity issuances, they are much smaller. About 80 percent of the cash that is distributed through repurchases comes back in through equity issuances. And about 40 percent of repurchases are used to repurchase shares that are given to employees and executives.

Mr. HUIZENGA. I'm sorry. My time has expired. I would like to follow up on that, and I am curious to continue the conversation on this today, disclosure, whether it is front-end or post-fact. But we will follow up.

And, Madam Chairwoman, I will take a moment, as well, to just ask unanimous consent that a letter from the National Association of Manufacturers be inserted in the record.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. HUIZENGA. Thank you.

Chairwoman MALONEY. The gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Chairwoman Maloney, listening to this very informative discussion, I really think that the heart of the issue here today is this: Why would a company, any company, make the choice to give back money to their shareholders rather than making an investment in the future growth of the company?

Companies could choose to improve workers' benefits, increase training. They could also choose to invest in new technologies and other actions that would expand the growth of the company. But why would they not choose these opportunities? Why do they find them less attractive than returning money to shareholders through a buyout?

And, so, I think that I want to ask you first, Ms. Palladino, why is this? What are the factors? It seems to me, if I am a CEO, how do I gain?

Here is what I think, and I believe the statistics will point out, that when you buy back that stock, does the price of the stock increase? That is the bottom line. Could you expound on that?

I will get to you, too, Mr. Lewis, because I think fundamentally, this is where we are to get to the truth of the matter. Because if I am a CEO and I have to make a choice, I think we need to be honest with this situation. It is clear that the CEO is the CEO to make more money and profits. I think that is why they buy back the stock. But correct me if I am wrong, Ms. Palladino.

Ms. PALLADINO. No, thank you. That is an excellent point, and I appreciate the question.

I think that we see really two reasons why executives are engaged in the volume of stock buybacks that we see today. One is the issue that both myself and Professor Fried spoke about, which is that corporate executives have to increase their own compensation because they do not have to disclose that they have conducted stock buybacks until about 10 or 11 weeks after the close of the quarter.

I think at a deeper level, though, we are talking about an imbalance of power in our economy where we have activist investors, we have large pools of capital, that are putting tremendous pressure on boards and CEOs to return capital as quickly as possible to shareholders without considering the effect that has on the workforce.

Mr. SCOTT. Mr. Lewis, do you have a counter to what she is saying, or do you agree with her?

Mr. LEWIS. I actually do not agree with her. My view is fairly simple. I think CEOs have particular expertise in things that they are very good at, and they make investments in the businesses that they know best. The idea of taking excess cash that they no longer have productive investments in their own business and finding new investment opportunities probably leads to less valuable investment choices in the long run than if you were to give it to somebody who actually is an expert at evaluating those new technologies. So, it is one way of taking money from firms that really do not have a good use for it and putting it in the hands of other entrepreneurs who actually have a valuable use for it.

Mr. SCOTT. Mr. Fried, where do you come down on this?

Mr. FRIED. People invest in new companies with the hope of making a profit. They bargain for arrangements that give them the right to throw out the board if the board does not hire a good CEO and does not deploy the money wisely. That is why people invest in companies.

When a company no longer has a way to profitably deploy money, then the right thing to do, from the point of view of the shareholders who originally put money in, is to send it back. And that is why we see capital flowing out of companies.

Mr. SCOTT. And Ms. Grice? My time has expired?

Chairwoman MALONEY. Your time has expired. We will go to a second round.

Mr. Hill, you are recognized for 5 minutes.

Mr. HILL. Thank you, Madam Chairwoman, and I appreciate your great leadership of this subcommittee and picking this timely topic to talk about. I think this is the third time that we have addressed the stock buyback issue during this Congress.

I have some slides I wanted to run through quickly just to set the stage.

This first one talks about growth investment, because I have heard from my friends that people are not investing in their companies; that instead, they are using that money imprudently to invest in stock buybacks. This is since 1990, and you can see in 2018 that we are at a really almost all-time high at 17 percent in the S&P 500.

Let's go to the next slide. Stock buybacks, as was noted in everybody's opening testimony, did increase after tax reform. In my view, this is a positive thing. Buybacks are tied to the growth in profits in corporate America, so the more profitable companies are, the more they might consider a stock buyback. And certainly, the 2017 impact of the tax reform caused, in the S&P 500, more cash to be re-invested in the United States. And in addition to investing in people and capital investment, they did invest in buying their stock back. So, I view this as sort of a transitory period.

Most of that money, I would say, when you look at it, came from just 20 stocks in the S&P 500, Madam Chairwoman, and those 20 stocks had the most money trapped offshore. So, that money came back into the United States and they did participate in the stock buybacks.

Let's go to the next slide. The pace of investment, as I say, over the long haul is still in that range. Investing in companies, you see the December 2017 tax enactment, but growth has only grown.

This is growth in companies in R&D, capital expenditures, and research. It has all been a positive story in the last 30 years.

Let's go to one more slide. And then, the S&P 500 cash return payout ratios, a dividend's net of buybacks. You can see that the return of cash historically is still in that historic range where it has been. And I just would argue whether it is paid back in stock buybacks or dividends, it is good for investors, and who does gain here are the investors in our pension plans and our 401(k) plans. This money does not go nowhere. It goes back out into our economy, as Mr. Coffey argued.

And I read in your materials that you have a great background in intrinsic investing. I wanted to read a quote from someone whom you admire, that you put in your marketing materials, Warren Buffett. Warren Buffett, CEO at Berkshire Hathaway, says, "Stock buybacks are sensible for a company when its shares sell at a meaningful discount to conservatively calculated intrinsic value—which you have in your testimony—. Indeed, disciplined repurchases are the surest way to use funds intelligently. It's hard to go wrong when you're buying dollar bills for 80 cents or less."

Do you agree with that, Mr. Coffey?

Mr. COFFEY. Absolutely.

Mr. HILL. Good. And he says, don't forget, companies who do that inefficiently are what? Are they punished by the market if they overpay?

Mr. COFFEY. Absolutely.

Mr. HILL. Thank you, Mr. Coffey.

Also, I noted that a company in my State was referenced. And Ms. Grice, thank you for coming and advocating today on behalf of the workers at Walmart. I live in Arkansas, which is the home to Walmart's headquarters, and I am proud to have them headquartered there in our State.

And I don't think anybody has worked harder to meet this dual effort of trying to invest in their employees since the tax plan was announced. They have made over $4.5 billion in workforce increases and raised wages, and tried to address many of the challenges that you talked about in your experience in South Carolina, which I really took quite fully from your testimony.

Doug McMillon, who is the CEO there, started out as a teenager earning minimum wage, unloading trucks in the distribution center up there in northwest Arkansas, so I really believe that he understands that balance that is so important to raise wages, which is why 60 percent of their employment is now full-time, which I think is one of the highest in the retail industry. They are a major employer, and I think, in a major way, committed to expanding opportunity for their managers and for their workers. I was looking at total wages and benefits of their hourly, full-time employees, and when you include the benefit package that Walmart offers, it looked like it was over $19 per hour.

Professor Lewis, I wondered—and "Anchor Down," by the way; I am a Vanderbilt graduate, so God bless Vanderbilt Law School.

SEC Chairman Jay Clayton said it was not in the purview of the SEC to make these decisions about capital allocation, when he has testified and been in public. Do you agree it is not the Commission's view to try to determine asset allocation?

Mr. LEWIS. Yes, I do.

Mr. HILL. Well, my time is running out, Madam Chairwoman. I will follow up in writing, and I thank the witnesses. This has been an excellent hearing. Thank you.

Chairwoman MALONEY. Thank you.

The gentleman from California, Mr. Vargas, is recognized for 5 minutes.

Mr. VARGAS. Thank you very much, Madam Chairwoman, and I want to thank all of the panelists who are here today.

My good friend from Arkansas just said that companies are punished if they do not buy a dollar for 80 cents, and I think that certainly would be true. But, Mr. Coffey, I think I have a timing issue here. Now, you said, if I heard you correctly, that if a company had a short-term financial scheme in your portfolio, you would remove them from your portfolio if they did that. But how would you know that before they repurchased their stock? How would you define that if there is no notice to you? How would you know that as opposed to the rest of the market?

Mr. COFFEY. That is a fantastic question. Actually, one of the things that companies are required to file, in addition to the 10-K and 10-Q, which provides a quarterly and annual reporting, is also the proxy statement, which outlines the board-approved compensation plan for the executives. And, so, we look at that, and we look at it when buying a company. We look at executive compensation. We look at how companies are incentivized. And then, we also look at their activities, and it takes time. It is not immediate. It takes time. If we bought a company in a quarter—

Mr. VARGAS. But that is my point, if I may interrupt you just for a second. You find out about it afterwards, right? I think you would find out about it after it happened.

Mr. COFFEY. Or, before we purchase it.

Mr. VARGAS. By that point, the executive could have in fact enriched himself or herself. You are finding out about it and you want to remove them from the portfolio, which is fine, but it has already happened.

Mr. COFFEY. Or, we find out before we even purchase it. In our due diligence, we are looking at a company and we are reviewing those results and we are trying to make a decision as to who we buy, and we do a risk-reward assessment, and we pick the company that has the best corporate governance.

Mr. VARGAS. Thank you. I don't want to run out of time.

Mr. Fried, I want to ask you about that, because you talked about timing, and I do have that concern. It does seem like an executive—and you noticed that a number of the actual repurchases are from employees, executives. Isn't there potentially a real timing issue here?

Mr. FRIED. The timing issue that I focus on in my written testimony is the timing of disclosure around the firm's repurchases of its own stock. So, if you are a corporate insider, you have to disclose within 2 days the details of every trade. If you are a firm, you disclose several months later, and it is on an aggregate monthly basis, so you cannot see individual trades.

That means that the people who are making the repurchase decisions can go into the market when the stock is dipped, buy up a bunch of shares, which benefits them because they own stock in the company, but it comes at the expense of public investors, generally.

They can also apply pressure to the price when they are selling to boost the price. We cannot see it. We cannot see it because we do not see the individual trades. We cannot apply Rule 10b-5. We cannot apply the anti-manipulation laws because we cannot see what is happening.

Mr. VARGAS. Would you disagree with that, Mr. Coffey?

Mr. COFFEY. There are a couple of ways that we do know. There are obviously 8-K disclosures. There is also Form 4, which indicates insider buying and insider purchasing. We do not know it immediately, but we know it within enough time to react to it. And investors do find—

Mr. VARGAS. But you are reacting after.

Mr. COFFEY. Of course, after. We don't know that—

Mr. VARGAS. I think that is the problem.

Mr. COFFEY. But I do not think it prevents us from actually acting in a way that is in the best interest of our shareholders. The information is given to us, and the Street reacts to it. In Form 4, we see it. We know insider buying; we know insider selling. It is a powerful signal.

Mr. VARGAS. Ms. Palladino, would you agree with that?

Ms. PALLADINO. No. I think the fact that buybacks are not disclosed until the end of the quarter, and they are only disclosed on a monthly basis—and I have looked at this in my own research—means there is simply no way to know if executives are taking advantage, as Professor Fried said, of the fact that they have used corporate funds to conduct a buyback and personally benefitted. And in my own research, I have found a strong, significant relationship between increases in use of corporate funds on stock buybacks and the increase of insider share selling for their own personal gain.

Mr. VARGAS. I think I will end it right there with one caveat. My good friend from Arkansas did mention Vanderbilt, so I have to mention, Mr. Fried, that I think you were one year behind me at Harvard Law School. You were Class of 1992?

Mr. FRIED. Thank you for paving the way for me, yes.

[laughter]

Mr. VARGAS. You had more black hair then, and so did I. Thank you.

Chairwoman MALONEY. Thank you.

The gentleman from Ohio, Mr. Davidson, is recognized for 5 minutes.

Mr. DAVIDSON. Thank you, Madam Chairwoman. And thank you to our witnesses. I appreciate the discussion of an important feature of America's capital markets frankly, the private ownership of capital.

Let's be clear. The owners of the firm are not the managers. The owners of the firm are the shareholders, and so the shareholders own that capital. And, of course, they hire the managers collectively to find a return on it. In fact, the return on the invested capital is largely the point of putting the capital at risk.

And I guess I would just like to make the point that, when you look at the capital structure—let's go straight to the balance sheet.

Some of the viewers maybe are not familiar with the standard assets equal liabilities plus equity. And, so, the firm might have some cash on the books, and a whole host of other assets, but the capital structure is largely comprised of a combination of liabilities and equity, the equity being the shares, and the liability potentially being the debt.

Right now, in the current capital markets, debt capital is far less expensive than equity capital. Far less expensive. So if your job, as a manager of a firm, is to get a return on the invested capital, wouldn't it be rational to use less expensive capital as long as you don't hurt the performance of the firm by over-levering the firm?

Anyone might find in their own personal household, for example, that some debt might make some sense. Maybe it is okay to have a mortgage on the house. But too much debt creates real risks. But, if you are in an all-cash position, you are all equity, it is more expensive to operate. You can get a better return on the invested capital. You can certainly get a better return on equity.

Mr. Coffey, you highlighted that, frankly, at the time people buy shares back, you cannot really be sure whether their decision to buy them back is righteous or not. It might make sense for a firm to buy the capital back and lower their cost of capital and put the returns there, and over time, you can see the fruit of that.

What do you find is in the data that you have collected, under the current rules of the game, what is the holding period that you can start to see, did that share buyback prove to be the right decision by management on behalf of the shareholders or not?

Mr. COFFEY. Over the course of our experience, again, we are long-term holders; we are lower turnover. I think, within our first year, we will be able to start seeing results.

The first thing that we will do, and this is important in our process, is we actually go visit management. If you are engaging in a share buyback or any other capital allocation activity we do not agree with, we have a conversation. If we do not see the results showing up in quarterly earnings after a certain period after we made our initial investment, usually after that first year, we are asking, where are the results, and are we making progress, and are there better investment opportunities?

Mr. DAVIDSON. Right, and that is one of the things. When you look, you are buying equities, frankly. When you look at publicly traded companies, there is that pressure, you have to deliver results inside a year. Inside a quarter in some cases, right? But some of the capital projects that are out there, depending on the industry, take aerospace or energy for example, you are not even looking at a positive cash flow event for 5 to 10 years.

You are looking at, how do you assess that? And who is in the best place, who is supposed to be in the best place, to assess the performance of the firm? The owners are supposed to be. That is why they hire or fire the management.

Mr. Lewis, as you have highlighted the important functions of share buybacks, I guess that is one thing I had not heard as much, is the cost of capital and how that affects the performance of the firm. How does that fit with the rest of the analysis that you have provided thus far and the concerns in the publicly traded space for the cost of capital?

Mr. LEWIS. You are right. I did not actually address the role of using share buybacks to basically optimize your capital structure, but it is one of the important features that a CEO and a CFO, one of the tools they would have at their disposal to try to get to a better mix, a better blending of debt and equity financing. And as you point out, debt financing is typically less expensive than equity, largely because interest payments generate a tax shield, and dividend payments to shareholders are not tax deductible at the corporate level. So, when you look at the two, there is a natural preference.

Mr. DAVIDSON. Opposite cash flow consequences for the firm. And I think opposite consequences for our economy if we impair the ability to just keep part of our capital markets. Thank you, and my time has expired. I yield back.

Chairwoman MALONEY. Thank you very much.

The gentleman from Illinois, Mr. Garcia, is recognized for 5 minutes.

Mr. GARCIA OF ILLINOIS. Thank you, Madam Chairwoman. I would like to begin with Ms. Grice and your powerful testimony today. Your story is representative of so many workers at Walmart and other companies around the country. You described doing years of stressful work at low wages, not controlling your work schedule and being able to plan around it for family purposes. And you said that your starting wage, if I heard you correctly, was at $7.78 per hour. For how many years did you earn that wage?

Ms. GRICE. Well, I don't even think I made that wage for a year because I moved up pretty quickly with the company. I was one of those people whom management looked at as a good leader, so I did not stay in that position long, making $7.78. That was back in 2013 when I started, and I started out with $7.78 an hour.

Mr. GARCIA OF ILLINOIS. How many years total did you work there?

Ms. GRICE. I worked for Walmart for 4 years.

Mr. GARCIA OF ILLINOIS. Four years?

Ms. GRICE. Four years; yes, sir.

Mr. GARCIA OF ILLINOIS. I can imagine that you were pretty outraged to read about the $20 million in buybacks that Walmart's board authorized through 2018 and 2019. The Roosevelt Institute found that if Walmart had redirected $10 million of that toward one million employees, they could have given those employees an hourly wage increase of over $5.66 an hour.

When Walmart issues stock buybacks, the largest gains go toward a small handful of wealthy individuals. A single family, the Waltons, own roughly half of Walmart's shares. The Walmart Company's net worth is estimated to be around $201 billion.

I also want to focus on the additional stress that an unreliable schedule can add when you are working a minimum or hourly job like yours, Ms. Grice. Raising a family, arranging for childcare, juggling a second job, or taking night classes to pursue another career can be challenging enough, even if your hours are predictable. It is tougher still when you do not have reliable scheduling.

But, clearly, Walmart is prioritizing shareholders over the interests of the millions that it employs. And you mentioned your colleague, Cat Davis, who filed a shareholder proposal demanding hourly employees be considered for Walmart's board.

Can you tell me what it would mean for employees like you to have more of a voice in how a giant corporation like Walmart is run?

Ms. GRICE. Well, it would mean a lot for us. There are a lot of things that go on in these stores that the corporate or home office has no clue about. So, being able to have someone who is inside those stores day to day, who knows exactly what goes on—the blatant disrespect, not getting full-time hours, not being able to get full benefits because you are part-time—means there is a lot that an associate would be able to bring to the board of directors.

Mr. GARCIA OF ILLINOIS. I also want to talk about another aspect of your testimony. Last month, the activist hedge fund, Elliott Management, launched a campaign to pressure AT&T to increase its stock buybacks and split its cash flow between debt and payments and buybacks. As of June 30th, AT&T had $22 billion in free cash flow available.

Ms. Palladino, when a company like AT&T has a cash flow of that size on hand, what are some of the long-term investment options available to it?

Ms. PALLADINO. I appreciate you bringing that up, because I think that the letter from Elliott Management about AT&T really highlights the kind of pressure that we know that activist investors are bringing on companies like AT&T, in which they call for an increase in stock buybacks. Because they are virtually unregulated, they are able to call for that increase. And, essentially, they called for a reduction in the workforce. With that kind of free cash flow, a company like AT&T could provide broadband, invest in upgrading our nation's infrastructure for the economy that is coming for the 21st Century, and, of course, continue to support an innovative and developing workforce.

Mr. GARCIA OF ILLINOIS. Thank you very much. I think my time has run out. Madam Chairwoman, I yield back.

Chairwoman MALONEY. I would like to thank all of our witnesses for their testimony today.

Is Mr. Hollingsworth here?

Mr. HUIZENGA. Mr. Hollingsworth is here.

Madam Chairwoman, I would like to submit a letter from the American Securities Association into the record.

Chairwoman MALONEY. Without objection, it is so ordered.

Mr. HUIZENGA. Thank you.

Chairwoman MALONEY. The gentleman from Indiana, Mr. Hollingsworth, is recognized for 5 minutes.

Mr. HOLLINGSWORTH. I apologize for being late. I wanted to ask Dr. Lewis about a few things. Number one, what in the short run determines an employee's wage?

Mr. LEWIS. What are the short-run determinants of an employee's wage?

Mr. HOLLINGSWORTH. Yes.

Mr. LEWIS. I assume employees' wages are based on a market for labor.

Mr. HOLLINGSWORTH. Right. Supply and demand.

Mr. LEWIS. Supply and demand.

Mr. HOLLINGSWORTH. Yes. As demand goes up, and supply is relatively static, wages go up, right? As demand falls, and supply remains relatively static, most likely it gets translated into wages, right? And, ultimately, that price clears the market?

Mr. LEWIS. Right.

Mr. HOLLINGSWORTH. It is not an altruistic offering by a corporation that determines an employee's wage. In the short run, it is the supply and demand.

In the long run, it is the marginal productivity of labor. As we increase the productivity of American workers, which we have done a fantastic job of over the last 40 years, that marginal productivity of labor continues to go up, and we can compensate labor in more enhanced ways through wages. I think it is really important to remember this.

The second thing I want to talk about is, is there any impact, is there any material impact, I should say, on a company's profit and loss statement, on their income sheet, from these corporate buybacks?

Mr. LEWIS. There has been a lot of discussion about the ability of sort of share buybacks to increase earnings per share.

Mr. HOLLINGSWORTH. It is an increase in earnings per share, but that is not an increase in the earnings of the firm.

Mr. LEWIS. You are correct.

Mr. HOLLINGSWORTH. In aggregate, the firm earns X, and then it uses a portion of that after-X income/after-X cash flow to purchase its shares, and may increase the earnings per share, but it does not change the aggregate earnings of the firm?

Mr. LEWIS. I was going to get to that, yes.

Mr. HOLLINGSWORTH. Okay. Sorry. I did not mean to cut you off.

Mr. LEWIS. Basically, the argument is that earnings per share are sort of artificially increased through a share repurchase program. The problem with that thinking is that is a completely mechanical adjustment. The firm is exactly the same firm before the buyback as it was after the buyback.

Mr. HOLLINGSWORTH. You are just dividing it by fewer shares?

Mr. LEWIS. You have a little bit less cash around, but the operations of the firm are still intact. You are still generating exactly the same cash flows from your business as you were before.

Mr. HOLLINGSWORTH. That is exactly right. I think that is a really important concept to remember because it would not be in a firm's interest—it is not as if a firm says, gosh, we have generated a certain amount of aggregate income, and we are looking for ways to deploy that aggregate income or cash flow, right? We can pay it back in dividends; we can reinvest it in the business; or, alternatively, we can buy our own shares back, which reduces the denominator of the number of shares outstanding.

But, it is not as though they are going to say, well, we should go back and maybe add more costs to our income sheet. It is not a choice—it is a fake choice to say, oh, gosh, this is a choice between wages and whether we buy more shares back. It is a real fake choice, because one is an income sheet-driven thing, right? Supply and demand for labor, wages, employee costs, personnel costs, et cetera.

The other is, what are we doing with after-tax cash flows in order to reinvest, enhance the returns to investors going forward, which makes our shares more attractive over the long run, and makes the business better over the long run if they plowed that back into the business or they plow that back into driving up those earnings over time, right?

Mr. LEWIS. That is right, if they plow it back into business in productive opportunities.

Mr. HOLLINGSWORTH. That is exactly right. And, so, I think it is really important to remember both. In the short run, wages are not affected by company policies. Wages are affected by the supply and demand of labor in that particular area, for that particular set of skills.

In the long run, us increasing the skills set of individuals, making them more productive—Americans are the most productive workers around the world, but we can make them even more productive with tools and capabilities, better training, better education, et cetera—increases their wages over time.

But it is not companies making a decision that gosh, we have some extra money lying around, maybe we should just go pay people more. Ultimately, that is going to be determined in whether that price, that wage, clears the market or not.

And I think it is really important to remember that these things that affect the income statement are separate than decisions about what we do with excess capital after they flow through the income statement. We have already made the revenue. We have already paid all of the costs of goods sold. We have already paid all of our overhead, whatever that may be. We have generated X at the bottom line, and now we are going to decide, how do we reinvest that?

Whether we invest that in lowering the number of shares outstanding, whether we invest that in buying more equipment, whether we invest that in new opportunities—buying new businesses, for example—that is a separate decision than, oh, gosh, maybe we should go back and use some of this bottom line to add more to our costs. They will not do that unless it is necessitated by the supply and demand in the market, right?

Mr. LEWIS. I would agree with that.

Mr. HOLLINGSWORTH. Right. Thank you. With that, I will yield back.

Chairwoman MALONEY. Thank you. And I would like to thank all of our witnesses for your testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

A P P E N D I X

October 17, 2019

Testimony of Derik Dwayne Coffey, CFA

Portfolio Specialist, Channing Capital Management, LLC

Before Financial Services Committee

Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

U.S. House of Representatives

On

Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment"

October 17, 2019

Introduction

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee, thank you for inviting me to testify. My name is Derik Dwayne Coffey. I am a Portfolio Specialist for Channing Capital Management.

Channing Background

By way of background, Channing Capital Management is a Chicago-based investment management boutique firm serving institutional investors that was founded in 2003. We currently have over $2 billion in assets under management and are a diverse owned firm with the majority share of the company's equity held by African Americans. We are a specialty investment manager focused primarily on Small/Mid cap investing with Domestic and International investment strategies. Long-term performance and tailored client service are long-standing precepts that drive everything we do. We firmly believe that by employing a research-intensive, fundamental, bottom-up process, we build portfolios positioned to generate solid long-term performance, with managed risk.

It is worth noting that while we have a diverse client base, a large portion of our clientele consists of public defined benefit pension plans. As you will see later in this presentation, our clients are heavily impacted by the capital allocation strategies employed by the companies underlying their investment portfolios. We take our fiduciary responsibility to our clients seriously as we execute our investment strategy to help them achieve their investment objectives.

What are stock buybacks and why do companies use them?

Allow me to now move on to addressing the primary topic on the agenda today: Stock buybacks. I would like to establish a base line for understanding of what stock buybacks are and why companies do them.

When discussing capital allocation strategies such investments as dividends or stock buybacks, the old maxim, "A bird in the hand is worth two in the bush," is often quoted. This ultimately means that investors generally prefer a dollar of dividends or share repurchases to a dollar of potential gains driven by capital appreciation. In short, investors view the certainty of upfront cash as less risky and generally prefer the assurance of receiving some cash in hand, which gives them options to decide where, when and how to deploy cash received to generate a higher return.

Capital allocation strategies such as dividends and buybacks are typically pursued after a company's Board of Directors has exhausted its options for deployment into initiatives such as Property, Plant and Equipment, Debt Reduction, Human Capital Investment, Research and Development, and or Mergers/Acquisitions. When capital levels exceed a company's expenditure needs, returning this capital to shareholders is considered a prudent strategy that enables and empowers investors to redeploy excess cash to areas where there may be more attractive growth opportunities. This keeps capital flowing so that our economy is always using capital it has available as efficiently as possible.

Buybacks are an important part of a company's capital allocation strategy and a company may engage in this activity for a number of reasons that I will outline below.

Reasons for Stock Buybacks

1. Management Capital Structure: A company's capital structure is its unique mix of debt and equity that is used to fund its assets. There are times when corporate managers need to adjust their capital structure to optimize or maintain efficiency or to lower their cost of capital. Buybacks offer a means for responsible management teams to adjust their capital structure when appropriate.
2. Added Flexibility: Relative to dividends, buybacks offer management team's flexibility as a form of capital return to shareholders. This is particularly true in an environment where earnings can fluctuate sharply from year-to-year. Dividends are extremely sticky and there is a large class of income sensitive investors that focus exclusively on dividend paying stocks. Any lowering or discontinuation of an expected dividend is typically met with an adverse reaction and most certainly a lower stocks price. Stock buybacks, on the other hand, give management teams more discretion to distribute excess capital opportunistically.
3. Offsetting Dilution from Employee Stock Options: For companies that compensate employees with stock options, buybacks offer an avenue to offset the potential dilution of earnings per share that could result from the exercise of stock options. For many companies the primary objective is to repurchase as many shares as have

been issued from the exercise of stock options to maintain a stable share count so as to not dilute existing shareholders interest.

4. Share Price Support/Signaling: This typically occurs when management views its own shares as undervalued. From a shareholder perspective, the announcement of a buyback program is often interpreted as a positive signal about the company's prospects and attractiveness. This is largely driven by the understanding that company's management has more information about the company's operations and future prospects than does an investor. Their commitment to the company gives investors' confidence that the management team has a more favorable outlook on the underlying business.

How Buybacks benefit our clients

Now that we have established what buybacks are and why companies do them, I would like to shift the discussion to how our clients specifically benefit from stock buybacks. As I noted earlier in my introduction, a large number of our clients are defined benefit plans but we also have decent and growing exposure to endowments/foundations, wealth management platforms and corporate plans. Our clients include Union Workers such as Policemen/women, Firemen, Teachers, City and State Workers. The common thread across all of these clients is they all benefit from stock buybacks. Allow me to outline how these clients directly benefit from them.

1. Better Management Alignment with Shareholders: Another advantage for buybacks over dividends is that the buybacks better align corporate management teams with shareholder interests particularly in cases where management owns a share of the company's equity. As buybacks reduce the number of shares outstanding, they also give management teams a greater share in the company's ownership structure. Numerous studies highlight that greater CEO ownership tends to lead to better long-term returns, which in our view, aligns well with the long-term interest of shareholders.
2. Boost in Share Price: When a company's shares decline in price, a management team that announces a buyback program can generally get a boost in the stock price. The benefit is generally driven by the positive signal to investors that management has a more optimistic view of its business than the market does. A second benefit is the potential uptick in demand for the shares in lieu of less shares being available to purchase. In this instance a lower share count coupled with positive affirmation from management should typically lead to higher share prices.
3. Tax Benefits: This argument applies specifically to taxable accounts. When excess cash is used to repurchase company stock, shareholders have the opportunity to defer capital gains if share prices increase. Moreover, buybacks are taxed at a capital gains tax rate, whereas non-qualified dividends are subject to ordinary income tax. If the stock has been held for more than one year, the gains would be subject to a lower capital gains tax rate.
4. Investor Choice: Buybacks give investors an opportunity to choose to sell their shares back to the company. A rational investor is less likely to sell their shares if there is no attractive alternatives means for deploying excess cash. In short, buybacks give investors a means to

receive and redeploy capital toward better growth opportunities and companies that are seeking capital.

Instances where Buybacks should require greater scrutiny

With that said there are definitely instances where stock buybacks do warrant greater scrutiny to prevent loss to investors. Buybacks that are used exclusively to achieve short-sighted goals via financial engineering are especially harmful. Examples of these activities typically occur in companies where management teams have performance incentives focused primarily on short-term targets. Many of these gimmicks include using stock buybacks to reduce shares outstanding to inflate earnings per share growth or to increase Return on Equity, a popular shareholder return metric. In these cases buybacks could contribute to giving investors a false impression that a company is adding value when it actually is not.

A second example where buybacks could be viewed as less advantageous are instances where a company has a long history share repurchases but continues to lose shareholder value despite these efforts. In these instances, investors, employees and politicians are right to question whether the buyback activity was the most prudent use of capital and if there were better uses for it.

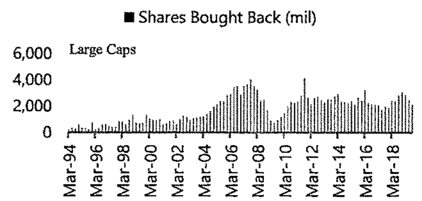
From Channing's perspective, we have to evaluate a business's forward outlook to make two determinations: 1) Is a stock buyback is the correct capital allocation decision? 2) Is the company's buyback strategy achieving the desired result? If management cannot garner shareholder support or drive value, we would eventually have to consider other options for our client's portfolios in order to generate higher returns.

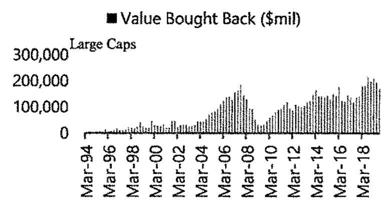
We have very little patience for management teams that use buybacks or other means to engage in short-sighted financial engineering schemes. If our analysts determine that a company's actions and incentives are myopic and/or not focused on long-term growth, our team voices these concerns to management. Ultimately we eliminate companies from our portfolio that fail to execute well and/or fall short on corporate governance.

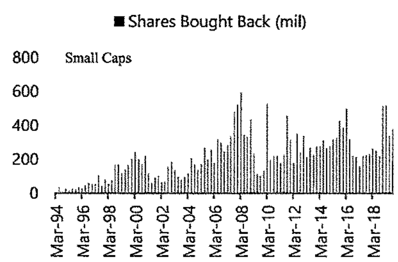
Why buybacks have surged over the past several years

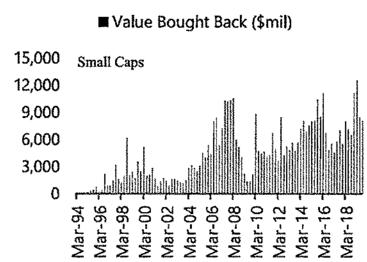
A question often asked in the news lately is why the pace of buybacks has accelerated over the past several years. I would like to offer our take on why buybacks have become a more popular means to distributing capital to shareholders in recent years. In our view the increase is driven by two things: 1) The extended duration of the bull market that started in 2009; and 2) the tax reform legislation that has encouraged more repatriation of overseas profits.

1) The extended duration of the bull market that started in 2009









Source: FactSet; Standard & Poor's; FTSE Russell; Jefferies

Per the charts above, stock buybacks have historically been more prolific during periods of economic expansion. In periods of economic growth companies are generally flush with cash to engage in capital investment and hiring. During these periods cash levels may actually exceed a company's capital expenditure needs. These are typical times when buyback activity increases. As the cycle matures and the economy slows down, buybacks tend to slow down commensurately with the need for businesses to preserve capital. Given these facts, it is no surprise that buybacks have surged across large and small capitalization stocks since the beginning of the current economic expansion that started in 2009. It is worth noting that stock repurchase activity was highest among large capitalization stocks during this period.

2) Tax reform legislation has encouraged more repatriation of overseas profits.

Prior to the 2017 Tax Cuts and Jobs Act (TCJA), the United States generally taxed its corporations and residents on their worldwide income. One way that businesses got around this potential tax liability was to leave the excess capital indefinitely in foreign subsidiaries. If a company decided to repatriate profits, these earnings would likely be taxed at a 35 percent rate and with credits provided for foreign taxes paid.

Following the passage of the TCJA, the United States government allowed the repatriation of overseas profits at preferred lower rates. There are two tax-preferred rates for the foreign earnings deemed repatriated: foreign earnings held in cash and cash equivalents were taxed at 15.5 percent and those not held in cash or cash equivalents at only 8 percent. The TCJA permits a US corporation to pay any tax on the deemed repatriations in installments over eight years.

Again it is worth noting that this activity was most rampant among large cap companies within the Technology Sector with substantial amounts of dollars trapped overseas before the tax reform legislation. The lower tax rates gave these businesses the incentives needed to bring this cash back to the U.S. while returning excess capital to shareholders.

Risk of Increased Restrictions on Buybacks

Any proposed legislation that is designed to stymie or retard buyback activity could result in negative outcomes for investors, the economy, and the optimal allocation of capital. The key question one should ask is whether it is better to legislate an issue that is cyclical, or one that reflects a structural imbalance. I would argue that the recent buyback activity is much more cyclical in nature. Allow me to outline some of the potentials pitfalls to investors of legislation that could potentially curtail buybacks.

1) Restrictions could trap capital in businesses that could lead to activity that deploys capital in a less efficient manner. One example of this would be a company making a less than optimal acquisition or overpaying for said companies. Decisions such as these ultimately costs jobs and waste capital while destroying shareholder value.
2) A buyback limitation could also impede the movement of capital from those that have it to those who need it. Many of our institutional clients benefit from this capital allocation activity as a source of funds to deploy capital.
3) Restrictions could also force businesses to increase the use of dividends as means for distributing excess capital. This could be less ideal for two reasons: 1) Dividends offer less flexibility for businesses to curtail once started; especially during weaker environments; 2) Investors with shorter holding periods, or Non-Qualified dividends, would be taxed at the ordinary income tax rate rather than the lower long-term capital gains rate.
4) Another consequence of a potential restriction on buybacks is the loss of a powerful signaling tool that investors rely upon to get a sense of confidence from management in the underlying business. A management team that is willing to buy shares, especially in a down market, helps to communicate optimism in the underlying fundamentals of the business.

Conclusion

In conclusion, I would like to thank the sub-committee for inviting me to address this important and timely topic.

To recap, buybacks play an essential role in how businesses deploy excess capital to shareholders. Second, a number of pension plans, and the employees that participate in them, directly benefit from buybacks. Buybacks provide an important source of capital to shareholders which allow us to redeploy the excess cash received to other productive uses. Third, companies that use buybacks to achieve short-sighted goals or to boost short-term metrics are heavily frowned upon. Our team seeks to own businesses focused on driving long-term shareholder value. Companies that invest in their business to gain market share, employ sound capital allocation and practice strong corporate governance, deliver better long-term results for our clients. Finally, legislation that is designed to restrict or limit buyback activity must be measured against negative externalities that could impair capital allocation that is critical for normal functioning markets.

I am happy to answer any questions you have.

Testimony of Professor Jesse M. Fried

Dane Professor of Law

Harvard Law School

Before the
Committee on Financial Services
Subcommittee on Investor Protection, Entrepreneurship, and Capital
Markets

United States House of Representatives

Hearing on

"Examining Corporate Priorities: The Impact of Stock Buybacks on
Workers, Communities, and Investment"

October 17, 2109

Chairwoman Maloney, Ranking Member Huizenga, and members of the Subcommittee: I thank you for inviting me to testify. Stock buybacks are an important and increasingly controversial feature of our capital markets. I am honored to have been asked to participate in this hearing.

I was asked for comment on the role of buybacks in the economy and their regulation, including: (1) whether the cash distributed via buybacks could instead be better used for other purposes, such as investing more in R&D; (2) the appropriate level of transparency surrounding buybacks; and (3) executives' conflicts of interest in buybacks related to their stock-based compensation.

I was also asked for comment on the following pieces of legislation: (1) H.R. ____, Stock Buyback Reform and Worker Dividend Act of 2019; (2) H.R. ____: Stock Buyback Disclosure Improvement Act of 2019; (3) H.R. 3355, Reward Work Act; and (4) H.R. ____, To amend the Securities Exchange Act of 1934 to require issuers to disclose to the Securities and Exchange Commission the details of any repurchase plan for an equity security, and to prohibit such a repurchase unless it is approved by the Commission (hereinafter, "SEC Approval Act").

In this statement, I share my background and credentials and then, in five Parts, offer my views on buybacks and my general reactions on the provisions in these pieces of legislation, some of which currently are in discussion-draft form.

Part I describes the role of stock buybacks in the economy and offers some "investor-benign" explanations for firms' use of repurchases rather than dividends to distribute cash to investors. Part I then explains that the overall level of shareholder payouts (that is, the total amount of dividends and repurchases) does not appear to be too high; in fact, it may well be too low.

Part II describes the current regulation of buybacks, which I believe is too lax and enables their abuse by corporate executives. In particular, I will explain how current regulation can enable executives to use buybacks to enrich themselves at the expense of public investors, through (1) indirect insider trading, (2) the manipulation of the stock price and EPS metrics in compensation arrangements, and (3) "false signaling:" announcing repurchases that executives do not intend to carry out, solely to boost the stock price before executives unload shares.

Part III suggests a disclosure rule that would reduce executives' ability to engage in the above-mentioned abuses, and therefore, better protect public investors: requiring public firms (like their insiders) to disclose trades in firm stock within two business days. I also describe additional measures that could be taken if this disclosure rule turns out be insufficient.

Part IV offers my initial reactions to key provisions in these four pieces of legislation. Part V concludes.

Background and Credentials

I am the Dane Professor of Law at Harvard Law School, where I teach courses on corporate law, corporate governance, securities regulation, executive compensation, and venture capital and private equity. Before joining the Harvard faculty in 2009, I was a Professor of Law and Faculty Co-Director of the Berkeley Center for Law, Business and the Economy (BCLBE) at the University of California, Berkeley. I have also been a visiting professor at Columbia University Law School, Hebrew University, IDC Herzilya, and Tel Aviv University. I hold an A.B. and A.M in Economics from Harvard University, and a J.D. *magna cum laude* from Harvard Law School.

I have authored over 40 academic articles on executive compensation, insider trading, corporate payout policy, corporate governance, and venture capital. My work has been published in the Harvard Law Review, Yale Law Journal, Harvard Business Review, Journal of Economic Perspectives, Journal of Financial Economics, and Journal of Corporate Finance. One of my main areas of research is executive compensation and insider trading. My book *Pay without Performance: the Unfulfilled Promise of Executive Compensation*, co-authored with Professor Lucian Bebchuk, has been translated into Arabic, Chinese, Japanese, and Italian. Another main area of research is share buybacks and capital flows in public companies.

I. Role of Buybacks in US Economy

A. Shareholders Payouts by Public Firms

Publicly traded U.S. firms annually generate hundreds of billions of dollars in earnings.[1] Each year, managers must decide how much of their firms' retained earnings should be distributed to shareholders through either repurchases or dividends, rather than remain in the firm for investment or other purposes. From shareholders' perspective, cash should be returned when the funds would generate more value for shareholders outside the firm than inside the firm.

In recent years, U.S. public firms have distributed around $1 trillion annually to their own shareholders through dividends and repurchases.[2] However, dividends and repurchases do not capture actual capital flows between shareholders. Firms issue large amounts of equity each year to shareholders, which moves cash from shareholders back to firms, either directly or indirectly.[3] Actual capital flows between shareholders and firms are measured by *net* shareholder payouts: dividends plus repurchases, less equity issuances.

[1] See Jesse M. Fried and Charles C.Y. Wang, Short-Termism and Capital Flows, 8 Rev. Corp. Fin. Stud. 207, 223 (2019) (hereinafter, "Fried and Wang, Short-Termism").
[2] Id.
[3] Id., at 212-222.

In 2018, U.S. public firms distributed about $1.4 trillion in dividends and repurchases to shareholders. But they also issued $750 billion of equity, directly or indirectly, to public shareholders. Net shareholder payouts—the cash shareholders were left with at the end of the year were therefore about $650 billion.

Net shareholder payouts from public firms become available for investment in private firms, which are typically younger and faster growing and absorb hundreds of billions of dollars per year in funding.[4] These private firms are vital to the U.S. economy and just as important as public firms. Such firms account for more than 50% of nonresidential fixed investment, employ almost 70% of U.S. workers, and generate nearly half of business profit.[5] Indeed, much of the critical innovation in our economy—including breakthroughs in pharmaceuticals and information technology—takes place in small, private firms.

In sum, shareholder payouts can benefit shareholders by enabling them to generate more value for themselves than if the cash is left in the firm. And shareholder payouts by public firms can thus benefit the economy as a whole by making capital available to smaller, growing firms that will engage in investment and hire American workers, the vast majority of whom work for private firms.

B. Investor-Benign Reasons for Repurchases

Managers must decide not only how much cash to distribute to shareholders but also the manner in which the cash should be paid out—through dividends, share repurchases, or both. During the 1980s and 1990s, many firms began using open market repurchases[6] to distribute cash, in addition to dividends or in place of dividends.[7] Currently, about 40% of distributions take the form of dividends and 60% take the form of repurchases.[8]

There are a number of reasons why it may be in shareholders' interest for managers to use a repurchase rather than a dividend.[9] The two most important are (1) tax savings and (2) the firm's ability to use a buyback to acquire shares to incentivize employees to generate shareholder value.

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[4] See Fried and Wang, Short-Termism, at 229.

[5] Id.

[6] Share repurchases can take the form of either an open market repurchase (OMR) or a repurchase tender offer (RTO). In an OMR, the firm buys its own stock on the market through a broker. In an RTO, the firm offers to buy back its own stock directly from shareholders, usually at a premium over the market price. See generally Jesse M. Fried, Insider Signaling and Insider Trading with Repurchase Tender Offers, 67 U. Chic. L. Rev., 421 (2000). OMRs are by far the most important. See generally Jesse M. Fried, Informed Trading and False Signaling with Open Market Repurchases, 93 Cal. L. Rev. 1323 (2005)(hereinafter, "Fried, Informed Trading"). My remarks here will focus on OMRs and throughout I will use the term "repurchases" to refer to OMRs.

[7] Fried, Informed Trading, at 1335.

[8] Fried and Wang, Short-Termism, at 212.

[9] Fried, Informed Trading, at 1336-1340.

Tax Efficiency. For U.S. taxable shareholders, repurchases tend to be a more tax-efficient means of receiving cash than dividends.[10] First, repurchases tend to shift the tax burden to shareholders with lower marginal rates. When a firm issues a dividend, all taxable shareholders are taxed on their pro rata share of the dividend. In contrast, when the firm repurchases shares, only those shareholders who choose to sell their shares are taxed. To the extent higher-bracket shareholders avoid selling their shares, leaving the selling to lower-bracket (or tax-exempt) shareholders, the aggregate tax burden on shareholders is reduced.

Second, repurchases allow tax-free recovery of "basis." A shareholder receiving a dividend is taxed on the entire amount. By contrast, a selling shareholder is not taxed on the full amount of the sale proceeds but only on the capital gains (the difference between the sale proceeds and the shareholder's cost basis in the stock). The tax-free recovery of basis, together with the bracket-shifting effect described earlier, can make repurchases more tax-efficient than dividends, even when the tax rates on dividend income and capital gains are the same.[11]

Employee Equity-Compensation Plans. A repurchase enables a firm to acquire shares for executive and employee equity-based pay programs, an important form of compensation in many firms designed to align executives' and employees' interests with those of shareholders.[12] Market-wide, over 50% of issued shares are given to employees; of these shares, 15% go to top-5 executives and 85% go to lower-ranking employees.[13] Issued shares total about 80% of repurchased shares.[14] Thus, market-wide, about 40% of repurchased shares are used for compensation.

It is important to understand how value moves when a firm repurchases a share and later issues the share to an employee, who then sells the share to public investors. The net effect is the same as a transaction in which the firm pays the employee cash, reducing the assets of the firm and the value of each shareholders' interest in it.[15] For example: the repurchase of a share for (say) $100 and the issuance of that share to an employee who sells the share for (say) $100 has the following effects: it puts $100 in the pocket of the employee and leaves shareholders owning a corporation that has $100 less in assets. In other words, it represents a movement of value from shareholders to employees of $100.

[10] Fried, Informed Trading, at 1336-38.
[11] U.S. nontaxable shareholders (such as pension funds) would be indifferent to the form of cash distribution. Foreign shareholders would generally prefer repurchases because of differences in withholding. See https://www.taxpolicycenter.org/taxvox/tackling-stock-buybacks-too-little-too-late-foreign-investors
[12] Fried, Informed Trading, at 1339.
[13] Fried and Wang, Short-Termism, at 214-16.
[14] Id., at 219.
[15] Id., at 214-216.

C. Assessing the Overall Volume of Shareholder Payouts

Critics of buybacks often compare the magnitude of shareholder payouts (dividends and repurchases) to net income, and conclude that public firms are depriving themselves of the resources necessary to grow. However, there are two problems in comparing shareholder payouts to net income.

First, as explained above, shareholder payouts are an incorrect measure of shareholder-firm capital flows because they exclude effects of equity issuances. Across the market, equity issuances total about 80% of repurchases and about 50% of shareholder payouts.[16] Market-wide, for every $100 of repurchases, firms issue $80 of equity; public investors thus net $20.

Second, net income is a poor measure of income available for investment: it assumes that the expenses deducted to arrive at net income are entirely unrelated to future-oriented investment. In fact, net income is computed after deducting the substantial expenses associated with R&D, which is by definition future oriented. From 2007 to 2016, for example, total R&D expenditures for S&P 500 companies equaled about 28% of total net income.[17] Therefore, net income at best measures the amount available for capital expenditures (CAPEX) and *additional* R&D.

A better measure of income available for investment is "R&D-adjusted net income," which adds a firm's R&D expenses (net of its effective tax rate) back to its net income. Net shareholder payouts as a percentage of R&D-adjusted net income appear quite low. From 2007 to 2016, net shareholder payouts by all public firms amounted to only 33% of R&D-adjusted net income. Even after net shareholder payouts these firms would have had $6.6 trillion available for CAPEX, R&D, and other investment by the end of 2016, even had they started the period with cash balances of zero.[18] (The results are similar after updating to include 2017 and 2018.)

In fact, during 2007-2016 overall investment climbed, reaching record levels in absolute terms and very high levels relative to revenues (so-called "investment intensity"). While overall investment intensity by public firms is volatile on a year-to-year basis, it increased during the decade 2007-2016, and ended the period near levels not seen since the late 1990s boom. By the end of this period, R&D intensity was at a historical high.[19] (Through 2018, overall investment and R&D have continued to increase, both in absolute terms and relative to revenues.)

Nor did a scarcity of cash constrain investment levels, preventing them from being even higher. Corporate cash stockpiles were huge and grew during the 2007-2016 decade. In 2007,

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[16] Fried and Wang, Short-Termism, at 219.
[17] Id., at 223-25.
[18] Id.
[19] Id., at 227.

public firms held $3.3 trillion in cash. By 2016, this amount had grown by nearly 50%, to $4.9 trillion.[20] These amounts continued to grow in 2017-2018, although there was a slight decline in 2018 relative to 2017. There is good reason to believe that much of this $5 trillion in idle cash sitting in public firms could be better invested in other firms.

Even if a particular firm's net shareholder payouts were very high relative to R&D-adjusted net income, that firm would not necessarily lack the capacity to invest and innovate, as it can simply issue more stock to public investors. The amount of equity issued by any given public firm in any given year does not represent a cap; the firm could generally have issued even more stock to raise cash, acquire assets, or pay employees.[21] Thus, if that firm has a valuable investment opportunity, but little cash, the firm can use equity financing to take advantage of the opportunity. Indeed, small, more quickly-growing public firms outside the S&P 500 issued more equity each year during the period 2007-2016 than they paid out in dividends and repurchases.[22]

II. Current Regulation and Executives' Abuse of Buybacks

A. Current Regulation

For our purposes, the three most important components of buyback regulation are: (1) disclosure requirements (both upon announcement of a buyback plan and after repurchases have commenced; (2) Rule 10b-5's prohibition against repurchasing shares on material nonpublic information; and (3) anti-manipulation rules.

Disclosure Requirements. Before it can begin buying back shares on the open market, a firm traded on NASDAQ or another stock exchange is required to announce its board's decision to approve an open-market buyback program.[23] But such an announcement need not provide specific details about the program. A firm is not required to indicate the number or dollar amount of shares to be repurchased. Nor must the firm indicate the expiration date of its buyback program. Even if a firm voluntarily indicates a repurchase target, it will typically state that actual repurchases will depend on market conditions. As a result, firms do not commit -- and are not obligated-- to buy back any stock. In fact, one study found that almost 30% of firms announcing repurchases do not buy back a single share during the fiscal year in which the repurchase announcement occurs, with about 15% not buying back any shares within four fiscal years of the announcement year.

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[20] Id., at 226-227.
[21] Id., at 228-229.
[22] Id. at 221-222.
[23] For all sources for this paragraph, see Jesse M. Fried, Insider Trading via the Corporation, 162 U. Penn. L. Rev. 801, 813 (2014) (hereinafter, "Fried, Insider Trading").

After a firm repurchases shares, it must provide very limited disclosure. Before 2003, a firm did not have to disclose any information regarding repurchases.[24] Since 2003, however, the SEC has required a repurchasing firm to report, in its quarterly Form 10-Q (or Form 10-K) filing with the SEC, the number of shares repurchased in each month of that quarter and the average price paid for each share. Because such filings can be made a month or so after the end of the quarter, investors cannot be expected to learn about share repurchases in the prior quarter until one to four months after they occur. By contrast, insiders of publicly-traded firms trading in their own firms' shares must disclose the details of each trade within two business days under Section 16(a) of the Securities Exchange Act of 1934.

Rule 10b-5. Rule 10b-5 requires persons owing a pre-existing fiduciary duty to the firm's shareholders, including corporate insiders, to disclose any material nonpublic information or abstain from trading in the firm's shares. The SEC takes the position that Rule 10b-5 also applies to a firm buying its own shares, even though a corporation is not considered to owe a fiduciary duty to its own shareholders.[25]

However, there are two limits to 10b-5's ability to prevent the firm from trading on all types of valuable inside information. First, the courts' high materiality threshold permits the firm to trade legally on many types of important but "sub-material" information.[26] Second, a prohibition against trading on "material" nonpublic information may not always deter such trading because of detection and enforcement problems.[27] Detecting a violation of Rule 10b-5 by a firm's insiders is difficult even though they must report individual trades under Section 16(a).[28] Because current trade-disclosure rules for the firm do not require a firm to report individual trades, but rather only monthly averages, it is even more difficult to detect a violation of Rule 10b-5 by a firm that repurchases its own shares while in possession of material inside information.

Anti-Manipulation Rules and the Rule 10b-18 Safe Harbor. Corporations, like individuals, are subject to the anti-manipulation provisions of Section 9(a)(2) of the Securities Exchange Act of 1934.[29] These provisions make it illegal to conduct a series of transactions creating actual or apparent active trading in a security to induce others to buy or sell the security. Purchases of a firm's own shares could be considered manipulative if the intent of the repurchase is to drive up the stock price by making it appear that there is unusually heavy demand for the stock.

In 1982, the SEC adopted Rule 10b-18, which provides repurchasing firms a "safe harbor" from anti-manipulation liability when they repurchase their shares in accordance with

[24] For all sources for this paragraph, see Fried, Insider Trading, at 814-815.
[25] Id., at 813-814.
[26] Id., at 808-809.
[27] Id.
[28] Id.at 813-814.
[29] Fried, Informed Trading, at 1341-42, for all sources in this and the following paragraph.

the rule's "manner, timing, price, and volume" conditions. The rule went into effect in 1983 and appears to have made managers more willing to engage in open market repurchases: the volume of repurchases increased sharply shortly after the rule became effective. But not all firms comply with these conditions. This is not surprising. It is not clear how the anti-manipulation provisions can be effectively enforced when regulators cannot easily observe the individual trades made by a firm in its own shares.

B. Executives' Abuse of Buybacks

Executives can use buybacks to transfer value from public investors to themselves, reducing investor returns and, perhaps, distorting corporate decision-making in a way that reduces the size of the overall economic pie.[30] This abuse is facilitated by the lax disclosure rules applicable to buybacks.

Indirect Insider Trading. Executives will have an incentive to conduct a buyback when they believe that the stock price is less than the stock's actual value (a "bargain repurchase"). A bargain repurchase transfers value from selling shareholders to non-selling shareholders pro rata.[31] Thus, to the extent insiders own shares in the firm and decline to sell their shares at a cheap price (which they can be expected to do), they will benefit from a bargain repurchase. Insiders of U.S. firms announcing repurchases tend to own a substantial fraction of the firms' shares before the repurchase -- an average of 15-20% -- which is roughly the same as the average insider ownership across all firms. Thus, when insiders know that stock prices are low, they have a strong incentive to conduct a bargain repurchase to transfer value from selling shareholders to themselves and other non-selling shareholders. There is substantial evidence of bargain repurchases, and I have estimated that insiders divert about $5 billion annually through them, at the expense of public investors.[32]

This indirect insider trading is facilitated by the current disclosure rules, which make it difficult to enforce Rule 10b-5 against the firm and which fail to provide public investors with real-time disclosure about the firm's repurchase activity. For example, if investors knew that the firm was aggressively buying shares, they might infer that the stock is underpriced and reassess their valuations of the firm, causing the price to rise and making it harder for insiders to conduct a bargain repurchase.

EPS and Stock-Price Manipulation. There is evidence consistent with executives engaging in buybacks to boost EPS when they are in danger of falling short of forecasted EPS,[33] although it is unclear whether public investors are harmed. Executives might also conduct

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[30] See generally Fried, Informed Trading and Fried, Insider Trading.
[31] See Fried, Insider Trading, at 815-820, for all sources relevant to this paragraph.
[32] Fried, Informed Trading, at 1357-1360.
[33] Heitor Almeida, Vyacheslav Fos, and Mathias Kronlund, The Real Effects of Share Repurchases, J. Fin. Econ. (2016).

repurchases to exert upward price pressure on the stock while selling their shares,[34] which would systematically transfer value from public investors to themselves. Depending on how executives' EPS-based bonuses are structured, executives might have an incentive to buy back shares simply to trigger a bonus, which again enriches them at public investors' expense. The lack of detailed, timely disclosure of repurchases emboldens insiders to engage in these strategies by making the abuse difficult to detect.

False Signaling with Misleading Repurchase Announcements. Managers wishing to sell their own shares at a higher price may have an incentive to announce a share repurchase they do not intend to conduct simply to boost the stock price.[35] A repurchase program announcement is generally greeted favorably by the market, as it can signal the stock is undervalued or that excess cash will finally be distributed (rather than being wasted or left to languish inside the firm). By announcing a repurchase program even when they have no intention of repurchasing stock, managers about to sell their own shares essentially attempt to "mimic" managers of firms that use repurchases to buy stock at a low price (or simply to distribute cash). This mimicking appears to be successful: there is no difference in market reaction between announcements followed by repurchase activity and announcements not followed by actual buybacks. To the extent that managers use misleading repurchase announcements to sell their shares for more than their actual value, they transfer value from the parties buying their shares.

III. Two-Day Disclosure Rule

A. The Proposal

Section 16(a) of the Securities Exchange Act of 1934 currently requires corporate insiders to provide detailed information about any trade in their firm's shares within two business days. Firms trading in their own shares, by contrast, may wait months until they disclose the existence of trading activity in their own shares, and can get away with providing only aggregate data.

These lax trade-reporting rules make it easier for insiders to trade indirectly on inside information, imposing potentially large costs on public shareholders. And the easier it is for insiders to engage in bargain repurchases, the greater will be the stock price reaction to a buyback-plan announcement, which in turn makes false signaling more profitable for insiders. Finally, lax disclosure rules make it harder for regulators to detect the use of repurchases to boost the stock price before executive stock-unloading or to improperly achieve EPS hurdles in compensation arrangements.

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[34] See generally Lenore M. Palladino, Do Corporate Insiders use Stock Buybacks for Personal Gain? (Roosevelt Institute Working Paper, 2019).

[35] See Fried, Informed Trading, at 1352-56, which contains sources for the entire paragraph.

These costs would be reduced if a firm were subject to the same trade-disclosure requirements as its insiders. In particular, a corporation should be required to disclose each trade in its own shares within two business days of the transaction. [36] This two-day rule would improve transparency and provide public investors with a timely, accurate, and comprehensive picture of insiders' trading, both direct and indirect via the firm.

The proposed two-day rule would not unduly burden firms, just as Section 16(a) has not unduly burdened insiders. Indeed, the largest stock markets outside the United States already require even more timely disclosure by firms of trades in their own shares. For example, in the United Kingdom and Hong Kong, publicly traded firms must report all share repurchases to the stock exchange before trading begins the next business day. Japan requires same–day disclosure. If firms in Hong Kong, Japan, and the United Kingdom can disclose open–market transactions by the end of the trading day (or by the next morning), U.S. firms should be able to disclose their trades within two days without too much difficulty.

B. A Step in the Right Direction

A two-day disclosure rule would be a substantial improvement over existing disclosure requirements but might not go far enough. The two–day rule would still enable insiders to engage in some indirect insider trading, just as Section 16(a) permits insiders to engage in some direct insider trading.[37] Most importantly, to the extent the market does not immediately adjust to the information communicated by a trade disclosure, but rather does so only over time, a firm can continue to trade profitably on inside information even after the market begins adjusting to the information provided by its trade disclosures.

Because of the limitations of a two–day rule, a one–day or same-day rule for both firms and insiders would be even better. Insiders would have less time to trade secretly, directly or indirectly. And stock prices would have more time to impound the information signaled by trade disclosures, reducing insider-trading profits on subsequent trades.

Indeed, I have elsewhere proposed that both insiders and firms be required to disclose their planned trades in advance.[38] Such a pre-trading disclosure rule, I have shown, would substantially reduce the costs associated with direct and indirect insider trading.[39] Thus, I do not claim that the two–day rule proposed here is ideal. Rather, I see the adoption of such a rule as an easy (but important) step in the right direction—-a measure that would harmonize insider-trading rules, improve transparency in the capital markets, and substantially reduce

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[36] The rule should also apply to at-the-market (ATM) equity issuances.

[37] See Fried, Insider Trading, at 838.

[38] See Fried, Informed Trading, at 1375-76; Fried, Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure, 71 S. Cal. L. Rev. 303, 329-48 (1998)(hereinafter, "Fried, Reducing the Profitability").

[39] See Fried, Informed Trading at 1376–82; Fried, Reducing the Profitability, 353–64.

indirect insider trading and its costs. But should the detailed disclosure provided by the two-day rule indicate that abuses were continuing, more aggressive steps—such as requiring pre-trading disclosure—could be considered.

IV. Comments on Bills

I now turn to comment on the provisions of the four buyback-related bills. I will not focus on the technical details of each bill, as there is considerable overlap among them and some of these bills are in draft form. Instead, I will speak to the general desirability of the various types of regulatory approaches embodied in these bills, explaining why I think some of them do not go far enough while others go too far.

A. Improved Disclosure Around Initiation of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019, The Stock Buyback Disclosure Improvement Act of 2019, and the SEC Approval Act all require firms to make certain disclosures before commencing a stock buyback. Depending on the bill, these disclosures can include the rationale for the repurchase, whether any executive is purchasing or is permitted to sell stock during the pendency of the repurchase, and the source of funds for the repurchase.

I am skeptical that such disclosures will, by themselves, materially affect the ability of corporate executives to use repurchases for indirect insider trading, to boost the short-term stock price, or manipulate EPS metrics in compensation arrangements. However, it is possible such disclosure could have a beneficial "naming and shaming" effect or could cause a firm's board to better focus on certain aspects of their repurchase and compensation programs. The only certainty is that requiring firms to provide additional disclosures imposes transaction and additional legal costs on firms which, everything else equal, will reduce investor returns.

B. Prohibition on Certain Sales by Executives around Repurchase Announcements

The Stock Buyback Reform and Worker Dividend Act of 2019 prohibits executives from selling shares for 7 days after the announcement of the initiation, continuation, or increase in size of a repurchase program, with certain exceptions.

I am skeptical that this requirement will have much effect on executives, because the stock-price increase following a repurchase announcement, whether or not the announcement represents false signaling, is likely to endure beyond 7 days.

C. Improved Post-Repurchase Disclosure

The Stock Buyback Reform and Worker Dividend Act of 2019 requires each firm repurchasing its own stock to disclose, during the last business day of each week, the number of shares purchased in the previous week (if not zero) and the average price per share.

This disclosure requirement is a substantial improvement over the current requirement that firms need only disclose transactions on a monthly basis several months after-the-fact. The requirement would reduce executives' ability to engage in indirect insider trading by alerting the market more quickly as to information-driven trading so it could respond, as well as by making it easier to detect violations of Rule 10b-5. The requirement would also make it easier to spot repurchases designed to help executives sell their shares at a higher price or trigger EPS-based bonuses.

However, the requirement would not be as effective as the two-day disclosure rule I put forward, because (1) it could take 9 more days for trading to be revealed and (2) the trade information be less granular, making it more difficult for investors and regulators to identify particular days on which problematic trading occurred.

The SEC Approval Act would require a repurchasing firm to disclose to the SEC, after the end of each calendar month, the "full details" of that month's repurchases, including the date, quantity, and price paid. The SEC Approval Act appears to contemplate the same type of granular disclosure as the two-day disclosure rule I put forward, which will make it easier to detect (1) violations of Rule 10b-5 and anti-manipulation rules and (2) attempts by executives to boost their bonus pay or the stock price. But the month lag time will make it more difficult for market participants to adjust valuations of the firm in light of recent repurchase activity, making it easier for insiders to trade indirectly on valuable information.

D. Elimination of the Rule 10b-18 Safe Harbor and Restrictions on Manner of Repurchases

The Stock Buyback Reform and Worker Dividend Act of 2019 eliminates the Rule 10b-18 safe harbor and imposes restrictions on the manner of repurchase. This may well provide a modest benefit in preventing use of repurchases to boost the short-term stock price.

Eliminating the Rule 10b-18 safe harbor, by itself, would likely have little effect unless firms came to believe that they were at greater risk for exposure to manipulation liability. To my knowledge, the SEC has not shown much interest in determining whether firms use repurchases to manipulate the stock price. And should that change, the disclosure requirements imposed by the Stock Buyback Reform and Worker Dividend Act of 2019 might not be sufficient to detect manipulative activity. The two-day disclosure rule I put forward, requiring detailed reporting of individual trades, would be more helpful.

E. SEC Approval Requirement for Repurchases

The SEC Approval Act gives the SEC the power to block a repurchase, after reviewing certain disclosures by the firm about the possible effects of the repurchase. As I indicated above, I don't believe that such disclosures by themselves are likely to make much difference in how repurchases are executed. And I am skeptical that the SEC would block any repurchases. If

I am correct, this SEC approval requirement would just drive up transaction costs, at investors' expense (and at the expense of the SEC's attention to other, more pressing, issues). If I am wrong, this requirement will tilt firms to dividends or slightly reduce the volume of repurchases, with the effect on investors unclear.

F. Outright Ban on Open-Market Repurchases

The Reward Work Act would ban open-market repurchases. Such a ban would likely be extremely disruptive to firms and very harmful to shareholders, as it would throw a monkey wrench into firms' equity-compensation arrangements, which have been built on the assumption that firms can continue to repurchase shares to give to executives and lower-level employees.[40]

There is no reason to do something so drastic before first adopting a two-day disclosure rule, which would likely reduce most of the abuses associated with repurchases. The two-day rule would also provide shareholders and regulators more information about how repurchases are executed, and enable a determination as to whether more aggressive regulation is required.

G. Beyond Repurchases

Two bills feature provisions that go beyond the regulation of repurchases. The Reward Work Act requires that at least 1/3 of an issuer's directors be employees (presumably in addition to the CEO and other high-level officers serving on the board). The Stock Buyback Reform and Worker Dividend Act of 2019 forces firms to pay employees a "worker dividend" based on the value of shares repurchased and any increase in the amount of ordinary dividends (or the issuance of special dividends).

In my view, adoption of either type of provision would create substantial dislocations in our capital markets, undermine our economy, and provide a windfall to the finance industry.

The Reward Work Act would reduce public-firm director accountability to investors. When more than a third of a company's board consists of executives or their direct or indirect reports, investors would need to win almost every other seat to wrest control from incumbent management. As a result, boards will have little incentive to properly allocate capital, including distributing it when necessary.

The Stock Buyback Reform and Worker Dividend Act of 2019 would not affect director accountability to investors, but essentially impose a tax on the return of capital, distorting the

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[40] It is possible that firms could, with sufficient advance notice, transition to using synthetic shares rather than actual stock.

flow of investment funds in the economy. And because this tax increases with the number of employees, we can expect public firms to hire fewer workers.

In either case, excess capital would flow more slowly out of firms and be mis-invested. Smaller companies would be deprived of funds, making it harder for them to innovate and hire workers.

Of course, firms do not have to remain public. They can go private. And many firms that are currently public will go private to escape this kind of intrusive regulation, which completely over-rides the bargained-for protections offered to investors providing capital to help these businesses grow. IPOs would dry up. Ordinary Americans will find it more difficult to invest in large businesses. There would also be a large payday for law firms, investment banks, corporate insiders, and private-equity firms that would profit substantially from taking these firms private. All of this would tend to increase income inequality.

V. Conclusion

The volume of share repurchases and dividends by public companies does not appear to be compromising these firms' ability to invest, innovate, or pay higher wages. Investment levels (CAPEX and R&D) are at record highs in absolute terms, and (over a 25-year time frame) either at record or near-record highs relative to revenues. Nor is investment constrained by lack of cash, as public firms are sitting on about $5 trillion of cash (even after record shareholder payouts). Individual public firms that are strapped for cash can always issue more equity to public investors, which they routinely do. Profits distributed by large, mature public firms are made available for smaller, faster-growing private firms, which employ more than two-thirds of private-sector workers.

Share repurchases can provide certain benefits to public investors. For example, they enable firms to acquire equity to grant to employees to align their interests with those of shareholders. However, executives can also use repurchases to transfer value from public investors to themselves, including through indirect insider trading. This abuse arises due to lax disclosure requirements around repurchases. Tightening disclosure requirements by requiring repurchases to be individually disclosed within two days would go far in reducing executives' abuse of repurchases, in a manner that does not interfere with the use of repurchases for benign purposes. Such detailed disclosure requirements would also enable Congress or the SEC to determine whether further steps are needed.

In my view, the provisions of the four repurchase-related bills under consideration either go too far, or do not go far enough, relative to the 2-day disclosure rule.

Thank you again for the opportunity to discuss this important subject, and I look forward to your questions.

Statement by

Janie Grice

United for Respect Leader

Testimony before the House Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets

Hearing on
"Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors"

October 17, 2019

Thank you Chairwoman Maloney and Congresswoman Waters for inviting me to speak today. I'm honored to be here. My name is Janie Grice and I'm from Marion, SC. I worked at Walmart as a cashier and later, as a customer service manager while I was raising my son as a single mother. I'm here today as a leader with United for Respect to speak on behalf of the 1.4 million associates who work for Walmart.

Most of you don't know Marion, SC. We're a small town in the American South that many have forgotten. When our first Walmart came to town, everyone was so excited. We had lost so many jobs when manufacturing factories shut down and moved overseas. Finally, we had jobs that paid well and where management treated you well. People used to love working at Walmart and shopping there. Then our little Walmart became a Supercenter and everything changed. All of a sudden, there were half as many available hours but twice as much work for each associate.

I had been trying for years to land a job at Walmart. People said it was a good company to work for, and the manager who hired me promised me full-time work. So I started out as a cashier working for $7.78 an hour. In my four years there, I never got to full-time employment or a stable schedule. Do you know how hard it is to spend time with your family or pay your bills when you have no clue how many hours of work you're going to get or when you're going to work?[1]

I always had to choose my job at Walmart over time with my son because without me working, we wouldn't have the things that we have. I want my son and grandson to have a better future, so I left to find something else even though I loved my Walmart family.

That's why I was so mad when I read about the $20 billion in buybacks from Walmart that made the executives and the Walton heirs even richer.[2] I don't mind investors making profits. I do mind when associates like me, who have been putting in the work day after day, year after year, don't get to share in those profits and our stores and customers get neglected.

It seems like Sam Walton is the only one who knew how to run a good business. He used to say that, "If you want the people in the stores taking care of the customers, you have to make sure you're taking care of the people in the stores." This is exactly why I filed a shareholder proposal at Walmart last year that would reward associates for our dedication and commitment to the company by getting a share of the profits from buybacks.[3] Shockingly, my proposal didn't pass.

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[1] https://populardemocracy.org/sites/default/files/201806112_OUR%20Walmart%20Full%20Report%20-%20Web.pdf
[2] https://www.thestreet.com/story/14337590/1/does-walmart-have-an-activist-problem.html
[3] https://www.vox.com/business-and-finance/2018/5/25/17379730/walmart-stock-buyback-worker-wages

But it started a real conversation about how corporations like Walmart need to make different choices instead of squeezing workers. Lenore Palladino who is here today has done some great research about Walmart and buybacks. She showed that just $10 billion of buybacks that Walmart authorized could have been used to give a million associates a $5 hourly wage bump.[4]

If I sat on Walmart's Board of Directors, I wouldn't think twice about approving that decision. Can you imagine how much turnover we could reduce? Or how many part-time Associates could get off of public benefits? Or what a high-road standard that would set for other companies? It's so painful to think that could have been a reality but a small group of people at the top decided not to prioritize associates like me.

And this isn't just happening in retail but also in other industries. While preparing to speak here, I learned about how workers at other companies were facing a similar fate as us. Wells Fargo authorized over $40 billion in buybacks since the 2017 tax bill. Meanwhile, a third of their workers make $15 an hour, and the bank keeps sending thousands of jobs overseas.[5] At AT&T, the hedge fund Elliott Management is pushing to sell parts of the company and use that money for stock buybacks- money that could be used to bring internet access to millions of workers and businesses.[6] It concerns me that these corporations are not prioritizing investments in workers, the companies, and the communities.

What these companies are doing with buybacks is both wrong and harmful to the majority of us. And we don't get a say in any of it. Think about what corporate America would look like if workers at Walmart, Wells Fargo, AT&T, Sears and other companies actually had a seat at the table. We would invest the corporate profits back into the company, the workers and investors- all of them.

My fellow United for Respect leader Cat Davis tried to drive this point home when she filed a shareholder proposal at Walmart this year to have hourly associates on the company's board. Her proposal makes the case that having stakeholders, like workers, on the board could actually lead to long-term financial returns and profitability for all of us. Right now, Walmart's pay is so low that a full-time associate earning Walmart's starting wage still falls below the federal poverty line for a family of three. How shameful is it that we have to live in poverty while working for the largest private employer in the world which has billionaire owners who are worth $175 billion?[7]

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[4] https://rooseveltinstitute.org/wp-content/uploads/2018/05/Walmart-issue-brief.pdf
[5] https://betterbanks.org/wp-content/uploads/2019/03/WheelAreStillOff_report.pdf
[6] https://cwa-union.org/sites/default/files/cwa-att-elliott-factsheet.pdf
[7] https://business.financialpost.com/news/retail-marketing/walton-family-fortune-balloons-to-175-2-billion-after-walmart-reports-hot-holiday-earnings

So what this committee is doing on regulating buybacks is really important. I'm here to ask you to seriously consider who you stand with: working people like me who work hard and reap little rewards, or corporate billionaires who will exploit every loophole to get richer?

By regulating how corporate profits are spent and who benefits from them, you are putting workers first and letting corporate America know that we matter. You're saying that if a company can issue billions in buybacks, it can afford a living wage and full-time employment for its workers. You're saying that it's time to end economic inequality in the U.S. so that working mothers like me can save for a better future for our kids.

There used to be a time in this country when two adults working 40 hours a week was good enough. It's not like that anymore. We have to work 2-3 jobs to make ends meet. We catch hell with all of the expenses and taxes we have to pay. We don't have billion dollar inheritances to fall back on like the Waltons do. But we have the power of our voices to call out corporations like Walmart for doing wrong by us.

Buybacks are a rigged game. They're not good for workers or for American companies. Whether you decide to ban them outright, regulate how they are issued, or pair them with a worker dividend, there needs to be bold, decisive action from all of you. The working people of America deserve a better shot at fairness and equality. Thank you.

HEARING BEFORE THE SUBCOMMITTEE ON INVESTOR PROTECTION, ENTREPRENEURSHIP, AND CAPITAL MARKETS OF THE COMMITTEE ON FINANCIAL SERVICES OF THE UNITED STATES HOUSE OF REPRESENTATIVES

Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment

Testimony of Craig M. Lewis
October 17, 2019

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee:

Thank you for inviting me to appear today to discuss corporate priorities as they relate to share repurchase program, workers, communities, and investment. I am the Madison S. Wigginton Professor of Finance at Vanderbilt University's Owen Graduate School of Management and a Professor of Law at the Vanderbilt School of Law. I have been on the faculty since 1987. From 2011 to 2014, I served as the Director of the Division of Economic and Risk Analysis and Chief Economist at the SEC.

1. General

The House Financial Services Committee is considering a number of regulatory initiatives designed to reduce or even eliminate the ability of corporations to repurchase shares. I discuss the economic substance of share repurchase programs and argue that share repurchases, or "stock buybacks," represent a highly efficient way to distribute cash to shareholders, and when compared to ordinary dividends, represent nothing more than an alternative mechanism for public corporations to distribute cash to shareholders.

As to my background, I helped develop the SEC's current approach that is used to evaluate the economic effects of rulemakings, and it is through that lens that I have made my comments.[1] To paraphrase the SEC's current guidance, a key requirement of any proposed rulemaking is the identification of the need for regulatory action and how the proposed rule will meet that need. An integral part of an economic analysis is to begin by identifying the "baseline." I will focus my remarks on the current baseline as a means to identify the main economic effects of stock buyback programs.

There are four House Bills under consideration: the Reward Work Act, the Stock Buyback Reform and Worker Dividend Act of 2019, the Stock Buyback Disclosure Improvement Act of 2019, and a fourth Stock Buyback Disclosure Bill. All of these rules reflect an implicit perspective that share repurchase programs represent a market failure that cannot be resolved through private action. Opponents of share buyback programs typically argue that they: 1) artificially inflate share price, 2) crowd out investment, 3) result from managerial short-termism, and 4) disproportionately benefit the wealthy and corporate insiders. I argue that these conjectures are either not supported by empirical analysis or are based on misconceptions about the how share repurchase programs actually operate.

I begin by characterizing the economic substance of share repurchase programs.[2] Although similar to ordinary dividends, share repurchases differ in several important ways. The most compelling examples include: 1) their ability to signal undervalued share price, 2) their role as a

[1] Division of Risk, Strategy, and Financial Innovation and the Office of the General Counsel, "Current Guidance on Economic Analysis in SEC Rulemakings," March 16, 2012, https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf

[2] Parts of my analysis are derived from Lewis (2018), which was a white paper commissioned by the Association of Mature American Citizens.

mechanism for distributing *excess* cash, 3) individual income tax advantages, and 4) reallocation effects.

- *Signaling undervalued share price.* In general, the announcement of share repurchase programs is associated with share price increases of approximately 2%.[3] The positive wealth effects are typically attributed to management trying (and succeeding) to signal that their firms are undervalued.[4] Stock buyback programs are viewed as credible signals to investors because managers typically hold non-trivial ownership stakes and would not personally benefit from overpayment. By having the firm repurchase shares at what they believe to be "fair" prices, management is effectively "putting its money where its mouths is."

- *Distributing excess cash reserves.* Investors have a tendency to view share repurchases as discretionary payments and ordinary dividends as non-discretionary obligations. In other words, when a firm announces a share repurchase program, investors do not interpret it as a long-term commitment. By contrast, once a firm begins paying ordinary dividends, investors expect them to continue to pay them, and will punish firms that cut dividends. For example, Dielman and Oppenheimer (1984) find that firms cutting dividends by more than 25% or omitting dividends entirely respectively experience abnormal returns of -7.7% and -8.1% on the announcement date. Given the downside risk associated with a dividend cut, firms respond by treating ordinary dividends as though they are just as important as new investment.[5]

  The other relevant consideration is that regardless of whether a firm elects to distribute past earnings as dividends, share repurchases, or if it chooses to let them to accumulate as cash on the balance sheet, earnings represent the return to the capital that shareholders put at risk. In a well-functioning capital market, the price that investors pay for future earnings reflects a fair rate of return for the risk they bear.

- *Individual income tax advantages.* Share repurchase programs confer significant tax advantages to shareholders relative to ordinary dividends. Ordinary dividends and long-term capital gains from the sale of shares (the difference between the sale price and the shareholder's tax basis) both qualify for a lower federal tax rate. When a shareholder receives an ordinary dividend, tax is due immediately and without regard to whether the shareholder has cash to pay the tax. By contrast, any additional value resulting from a

[3] Brav, Graham, Harvey, and Michaely (BGHM, 2005) survey 384 CEOs and report that 86.4% of all CEOs agree or strongly agree that they are able to time share repurchases to coincide with periods when stock is undervalued. Papers by Dann (1981), Vermaelen (1981, 1984), Asquith and Mullins (1986), Comment and Jarrel (1991), Ikenberry, Lakonishok, and Vermaelen (1995), Stephens and Weisbach (1998), Grullon and Michaely (2004), and Bhattacharya and Jacobsen (2018) all report consistently positive announcement date returns. More recently, SEC Commissioner Robert Jackson's office released a study (2018b) that documents an abnormal announcement date return of 1.17%. This reverses a previous 20-day cumulative abnormal return of -1.39%.

[4] By contrast, dividends appear to be perceived by investors as regularly scheduled announcements that are designed to convey management's on-going assessment of future profitability.

[5] Brav, Graham, Harvey, and Michaely (BGHM, 2005) survey 384 CEOs and find that "maintaining the dividend level is on par with investment decisions, while repurchases are made out of residual cash flow after investment spending."

share repurchase program is taxable only to those shareholders that elect to sell their shares, who then pay capital gains taxes.

- *Reallocation effects*. Another point that is often overlooked in the share repurchase debate is that the cash paid to shareholders does not disappear. Investors selling shares either spend the cash received on goods and services or reinvest it elsewhere. The reallocation of capital into consumption and other investments potentially redirects it to activities that have higher value than incremental investments available to firms. In the long-run, this stimulates growth and creates better jobs than would be possible if firms were to make suboptimal investments simply because the cash was available.

These explanations contrast sharply with critics who view stock buybacks as financial gimmicks, primarily aimed at "artificially" inflating share price. Consider Senator Elizabeth Warren's comment that, "*stock buybacks create a sugar high for the corporations. It boosts prices in the short run, but the real way to boost value of a corporation is to invest in the future, and they are not doing that.*" Senator Warren's quote is instructive because it highlights many of the misconceptions shared by critics of share repurchases.

- *Artificial price inflation*. Investors do, in fact, respond favorably to share repurchase announcements. This has led critics to conjecture that firms can engage in a type of price manipulation wherein they simply announce their intention to initiate share repurchase programs in the hope that prices will rise. This argument fails because it does not consider managerial incentives. When managers hold equity positions in the firms they manage, it would not be in their self-interest to overpay via share repurchase because to do so would subsidize departing shareholders at their expense.[6]

  If stock buy-backs are solely designed to artificially inflate valuations, stock prices would be expected to revert to pre-announcement levels once it became clear that higher prices could not be justified on the basis of the available information. The empirical evidence is inconsistent with this conjecture and finds instead that announcement date price increases are permanent.[7]

- *Inadequate future investment*. It is not possible to observe investment opportunities that a firm considered but did not take, yet we can determine whether share repurchases crowd out investment or merely reflect the distribution of excess cash. Contrary to the view that

[6] Jackson (2018a, 2018b) documents that some managers sell equity when buyback programs are in place. Although his analysis does not consider the size of insider residual equity stakes, many executives retain significant equity positions even after some of them may sell shares, leaving them with no incentive to repurchase shares at artificially inflated prices.

[7] Since firms tend to repurchase shares after stock price declines, managers tend to act in a manner consistent with their beliefs. For example, Jackson (2018b) finds that the 20-day cumulative abnormal return prior to the announcement of a stock buyback program is -1.39%. Studies of stock market reactions to share repurchase programs report positive announcement date returns, indicating that investors react as if they find such announcements to be credible signals of undervaluation. For example, a recent study by Dittmar and Fields (2015) finds positive announcement date returns of 1.87% that do not reverse. Ikenberry, Lakonishok, and Vermaelen (1995) find that the equity of firms initiating repurchase programs outperform a set of peer firms by 12.1% over the next four years.

firms cut back on capital investment to repurchase shares, I find that, on average, firms have been able to invest in new projects, pay dividends, and repurchase shares without constraint. In situations where such firms need additional funds, they are able to access capital markets to obtain the necessary funding. By contrast, firms that do not repurchase shares would be unable to fund new investment from earnings and needed to access capital markets to obtain the necessary funding.

- *Managerial Short-Termism*. There is a widely held belief that pressure by activist shareholders creates managerial incentives to meet short-term goals at the expense of long-term value maximization.[8] Proponents argue that managers frequently respond by repurchasing shares in an attempt to placate disgruntled investors. An analysis by Lazonick (2014) suggests that share repurchases and dividends absorb 91% of net income.[9] Using an appropriately adjusted definition of net income, I report numbers that are much lower. I find that firms only pay 47.10% of adjusted net income as dividends and share repurchases.[10] Moreover, firms are able to retain 36.26% of adjusted net income net of new external financing after investing in productive opportunities, paying ordinary dividends, and repurchasing shares. My estimates are low enough that payments to shareholders would not be expected to significantly impair a firm's ability to focus on long-term decisions.

  Repurchase Plans Disproportionately Benefit the Wealthy. It has been estimated that approximately one half of US families have direct or indirect investment in the stock market and that the proportion of families with equity exposure are an increasing function of age. Seniors, in particular, rely on equity markets to provide them with the ability to meet threshold spending levels in retirement. For example, a recent study by Brady (2017) examines individual W-2 tax return data and finds that participation and contribution rates for employer-sponsored retirement plans increase with age as individuals become more concerned about retirement. Brady (2017) reports that 68% of individuals aged 55 to 64 are active participants in a retirement plan or have a spouse who is an active participant, and this age group contributes an average of 7.7% of their wages to retirement plans.[11]

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[8] Consider the SEC's recent decision to study the possibility of semi-annual rather quarterly reporting. One of the motivating factors is the perception that managers feel compelled to meet short-term earnings targets rather than focusing on longer-term objectives,

[9] Fried and Wang (2018) find that after controlling for new share issuances and intangible investments, S&P 500 firms only return 46% of net income to shareholders. They base their findings on the observation that the Lazonick (2018) estimates are biased upward because net income does not consider intangible investments in research and development. Although the Fried and Wang (2028) estimates are much lower than Lazonick's, they continue to reflect an upward bias because net income also reflects a deduction for depreciation and amortization – a non-cash expense. In my analysis, I adjust net income by adding back depreciation and amortization ***and*** research and development expense.

[10] This estimate is obtained from Panel A of Table 1. It is calculated as the difference between Columns (5) and (3(, i.e., 64.74%-17.64%.

[11] By contrast, the corresponding participation rate for individuals aged 26 to 34 only is 52% to which they contribute an average of 4.4% of their wages. In a different analysis, the Survey of Income and Program Participation conducted by the U.S. Census Bureau reports that in 2014 seniors (the 65 and over age group) make significant directly investments in stocks and mutual funds. It reports that, on average, seniors hold about 40% of their net worth ($80,000/$198,000) in stocks and mutual funds that are invested outside of retirement accounts.

- *Repurchase Plans Disproportionately Benefit Corporate Insiders.* The argument that share repurchases disproportionately benefit corporate managers would only be true if share repurchases were being used to manipulate prices so that they could trade at artificially high levels. Given the discussion presented above, there is no evidence that this is the case. If, instead, share repurchase programs are used to signal "fair" value, investors and corporate insiders are simply realizing benefits that already should have accrued to them.[12]

  Regardless of whether executives sell or retain their shares, their wealth is effectively unchanged. If they sell shares in the open market, the receive cash at post-announcement prices. If they hold onto their shares, there investment would have appreciated by the same amount. Not only would executives be indifferent between selling and retaining shares based on price alone, these are the same choices available to every shareholder.

2. Do Share Repurchase Programs Constrain Investment?

The short answer is no.

Much of the current debate surrounding share buybacks stems from provisions in the Tax Cuts & Jobs Act of 2017 (TCJA) to tax unrepatriated foreign earnings. To the extent that the repatriation tax frees previously inaccessible cash, one would expect these firms to redeploy excess cash. Reacting to the propensity for firms to repurchase shares with this cash, Dr. Kevin Hassett, the White House's Chairman of the Council of Economic Advisors, offered the following at a February 2018 press conference:

> *"Well, the thing that you have to remember is that we're starting out with trillions of dollars that were parked overseas. And that trillions of dollars — those monies are*

[12] A recent speech by SEC Commissioner Robert Jackson ("Stock Buybacks and Corporate Cashouts" (2018a)) discusses the results of an SEC empirical analysis (2018b) that shows managers have a higher propensity to sell shares following the announcement of a share repurchase program. Commissioner Jackson notes that

> *"It's one thing for a corporate board and top executives to decide that a buyback is the right thing to do with the company's capital. It's another for them to use that decision as an opportunity to pocket some cash at the expense of the shareholders they have a duty to protect, the workers they employ, or the communities they serve."*

Although provocative, there are a number of mitigating factors that undermine this assertion. First, the extant empirical evidence suggests that investor reactions to buybacks are permanent rather than transitory. In effect, share repurchase programs help an undervalued stock reflect its true value. Consequently, it shouldn't matter when executives sell their shares following a buyback. Second, since most equity-based compensation has significant vesting periods, managers that sell their shares may be capturing performance improvements that have helped create. A third factor is the extent to which executives continue to hold significant equity stakes after the repurchase program is completed. A fourth consideration is that the period immediately following the announcement of a stock buyback is likely to be a time when an insider has a clear window within which to sell shares because it can be assumed that the market is fully informed. The decision to sell may simply reflect that this is a period that is free from potential conflicts of interest. Finally, insider sales could be the result of preplanned sales that are part of 10b5-1 plans. The decision to buyback shares ahead of periods where there is a significant amount of "exogenous" sales could reflect actions by the company to provide liquidity to mitigate liquidity-induced price pressure.

> *coming home right now and that's a one-time adjustment. And a lot of firms are taking that money and they're paying bonuses, but they're also doing things like increasing dividends and doing share buybacks, which sometimes happens when firms find money.*"

The idea that some firms announce share buybacks when they "find" money is hardly surprising. As Dr. Hassett suggests, there are many valid ways to redeploy "found" money. Firms that previously faced financial constrains may optimally increase investment spending. Alternatively, firms that were able to fully invest may not need the cash. For these firms, the decision to return cash to shareholders could be a better choice than retaining it for unspecified corporate purposes.

Excess cash balances are largely the result of the accumulation of retained earnings. Since the TCJA eliminated incentives to retain cash overseas, the uptick in stock buybacks is largely attributable to decisions by firms to make choices about how best to handle cash balances they may no longer need. Policy solutions that are designed to increase the cost of repurchasing shares impose a permanent cost on what is likely to be a transitory phenomenon.

One factor motivating the decision to repurchase shares could be a decision by corporate boards to actively limit managerial discretion over the unspent cash balances. Finance theory suggests that as managerial discretion increases, it becomes easier for managers to take actions that benefit themselves to the detriment of shareholders.[13] One only needs to look at the recent failure of the WeWork initial public offering to understand the importance of limiting managerial discretion. Former CEO, Adam Neuman, was asked to step-down once it became clear that investors were concerned about unprofitable operations and excessive perquisite spending.[14]

One of the most effective way to reduce managerial discretion is to eliminate excess cash balances via stock buybacks.[15] With less available cash, managers are forced to be more selective about investment choices. When cash balances are insufficient to fund new investment, firms must turn to external capital markets and face increased monitoring.

This raises a series of questions – What are the characteristics of firms that repurchase shares? Are they able to finance projects from cash flows? Do they access capital markets? What should firms do with cash that no longer required for investment?

Economic theory argues that new investment should only be taken if new projects are expected to earn returns that exceed the opportunity cost of capital. That is, a firm should only invest in

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[13] These conflicts range from excessive perquisite consumption to empire building. The former describes the fact that managers pay relatively small fractions of the cost of the perquisites they consume. The latter reflects the observation that managerial compensation is typically benchmarked to comparable firms. Since manager salary, benefits and status rises with firm size, managers have incentives to increase firm size, even if projects do not have positive net present value.

[14] Examples of inappropriate use of corporate assets include questionable acquisitions of unrelated businesses, a private jet that Mr. Neuman used to travel between New York and California, the hiring of at least one driver for his Maybach luxury car, and a small spa and ice bath that were reportedly attached to his office.

[15] Jensen (1986) has argued that agency costs of managerial discretion associated with excess cash leads to suboptimal investment.

projects that have positive net present value (NPV).[16] Suboptimal investments - those with negative NPVs - destroy firm value. When firms do not have attractive investment opportunities, repurchasing shares is a sensible alternative to investment in negative net present value projects.[17]

2.1 The empirical evidence of investment by firms that do and do not repurchase shares

I address this question by examining the investment activity of publicly traded companies over the years 2010 through 2017. Table 1 provides an analysis of gross investment rates (GI) relative to adjusted net income (NI). Gross investment represents the amount spent on capital assets, acquisitions, and research and development expense. Adjusted net income is a measure of the cash generated by operations that could be used by shareholders for investment purposes. I add back research and development expense because it is recognized as an expense for financial reporting purposes even though it is more appropriately viewed as speculative investment in future growth. I also add back depreciation expense because it is a non-cash expense that does not require the use of any funds. Adjusted net income is the amount that could be used to spend on investment, dividends, and share repurchases.[18]

2.2.1 Uses of cash for firms that repurchase shares

In Panel A of Table 1, Column (1) indicates that, on average, firms spend 78.04% of adjusted net income on gross investment. While this is a substantial amount, these firms also are active in debt and equity markets. For example, Column (2) shows that net debt issues are used to finance approximately 47% of gross investment (47% = (78.04-37.65)/78.04). This suggests that even though these firms could have financed gross investment from current cash flows, they chose to borrow funds. The decision to borrow may be a reflection of the relatively low interest rate environment that persisted over the sample period. Firms also financed new investment with equity (Column (3)). On average, equity issuances further reduced the impact of new gross investment relative to adjusted net income by 26% (26% = (37.65%-17.64%)/78.04%). The yearly numbers indicate that firms were particularly active in equity markets in 2013 and 2014.

Panel A also indicates the fraction of adjusted net income net of new capital that was used for investment and to pay dividends and repurchase shares. Column (4) reports that, on average, firms used 29.35% of adjusted net income to invest and pay ordinary dividends net of net borrowing and equity issuances. This suggests that, on average, firms were able to invest and pay ordinary dividends in a relatively unconstrained manner.

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[16] Net present value is an estimate of the wealth that is created (destroyed) when a projects cash flows are expected to earn more (less) than the opportunity cost of capital.

[17] One could argue that multinational corporations could simply continue to maintain large internal cash balances as a way to hedge against future funding uncertainties. This, of course, would not satisfy critics that would like to see the cash redeployed into new investment "opportunities" nor would it be a particularly effective use of corporate resources. One way to limit managerial discretion concerns is to liquidate excess cash balances by repurchasing shares.

[18] Data is obtained from Calcbench, a data provider that aggregates SEC XBRL filings. I apply several data filters: 1) firms must report revenue greater than 0, 2) firms must report total assets greater than 0, 3) to control for reporting errors, firms must have an end of period stock price greater than $10 and less than $2,000, 4) a firm's market capitalization of equity must exceed $1.0 million, and 5) adjusted net income must be greater than zero. I replicate the analysis without imposing the adjusted net income constraint and the results are highly similar.

On average, firms use 64.74% of adjusted net income (net of new financing) for new investment and cash payments to shareholders. Given that "repurchase" firms retain 35.26% of adjusted net income, they show no signs of being financially constrained, even after using 35.39% of adjusted net income to repurchase shares (64.74%-29.35%).

The main takeaway is that these firms have the capacity to invest in capital assets, pay dividends, repurchase shares and still have over one-third of adjusted net income remaining for other corporate uses.

2.2.2 Uses of cash for firms that do not repurchase shares
Panel B of Table 1 shows that firms that do not repurchase shares have gross investment levels that exceed adjusted net income. Column (1) reports that, on average, these firms would not be able to invest without accessing external capital markets – the ratio of gross investment to adjusted net income is 115.44%.

"Non-repurchase" firms have a tendency to rely on debt almost as much as firms that repurchase shares. For example, Column 2 of Panel B indicates that they borrow 40.39% of adjusted net income compared to 37.94% for firms that repurchase shares.[19] By contrast, "non-repurchase" firms issue significantly more equity than "repurchase" firms. Column 3 of Panel B finds that new equity issues are 65.91% (77.50%-11.59%) of adjusted net income for "non-repurchase" compared to 20.01% (37.65%-17.64%) for "repurchase" firms. Not surprisingly, firms that issue substantial amounts of new equity are unlikely to repurchase shares at the same time.

3. Key Economic Features of Bills Under Consideration

3.1 Bills that are designed to eliminate or constrain stock repurchase programs

The "Reward Work Act" and the "Stock Buyback Reform and Worker Dividend Act of 2019" are designed to reduce the ability of corporations to repurchase shares. The Reward Work Act calls for the outright prohibition of share repurchase programs. The second bill would require firms that repurchase shares to pay workers an amount proportional to 1-millionth of the amount spent to repurchase shares.

Both bills are based on the premise that if share repurchase programs are curtailed or become more expensive, firms will elect to increase investment in tangible and intangible assets (R&D) and pay workers more. This could happen if firms were to preference distributions to shareholders over investment in positive net present value projects. Given that, on average, firms are able to invest in profitable opportunities, pay dividends, and repurchase shares using a combination of adjusted income and access to capital markets, it is not clear why increasing the incentives to retain cash would lead to more efficient investment. If regulation creates incentives for firms to reinvest rather than distribute excess cash to shareholders, it would likely lead to an overinvestment problem in which firms would make inferior investments that would be unlikely to benefit the economy in the long-run.

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[19] These amounts are calculated as 40.39% (78.04%-37.65%) and 37.94% (115.44%-77.50%), respectively.

3.2 Bills that require enhanced disclosure of share purchase programs

The Stock Buyback Disclosure Improvement Act of 2019 and a second unnamed Stock Buyback Disclosure Bill are designed to increase transparency around share repurchase programs. The first bill is largely a response to Commissioner Jackson's views regarding executive participation is share repurchase programs. For reasons I note above (see footnote 10), I believe that the underlying research that informs these concerns fails to document a significant market failure.[20]

The second bill seeks to increase mandatory disclosure about the nature and purpose of planned share repurchase programs. This bill includes a requirement that firms must pre-announce a repurchase program 15 days prior to its execution. Since repurchase programs are typically executed over relatively long periods of time, it is unclear what the benefit of a mandatory pre-announcement has relative to the existing 8-K disclosure requirements.

The most surprising aspect of this bill is that the SEC would be required to approve buyback programs before they can be implemented. The decision to require a disclosure-based regulator like the SEC to become involved in financial policy decisions is unprecedented. Not only does the SEC lack the expertise to make such determinations, it is unclear how this serves the Commission tri-partite mission of investor protection, the maintenance of fair, orderly and efficient markets and the facilitation capital formation.

[20] Although the event-study framework reliably identifies significant stock price reactions on the announcement of material events, the use of cumulative abnormal returns to evaluate long-run stock price performance is not as reliable. Alternative approaches specifically designed to estimate long-run abnormal returns have been developed (buy-and-hold abnormal returns and calendar-portfolio returns), but even these methodologies have a number of econometric limitations that limit their usefulness.

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Table 1. Gross Investment (GI) Rates Relative to Adjusted Net Income (NI), 2010-2017

Year	GI/ NI (1)	(GI - Debt)/ NI (2)	(GI-Cap)/ NI (3)	(GI-Cap+Div)/ NI (4)	(GI-Cap+Pay)/ NI (5)
Panel A. Firms that repurchased shares					
2010	66.30%	49.96%	29.34%	39.59%	68.79%
2011	74.88%	37.99%	15.45%	26.15%	63.46%
2012	76.57%	44.08%	29.74%	42.51%	74.01%
2013	73.69%	30.64%	7.88%	17.50%	49.78%
2014	92.95%	32.75%	6.05%	17.57%	60.51%
2015	82.26%	36.40%	15.26%	29.18%	72.83%
2016	73.41%	37.07%	23.18%	36.14%	70.15%
2017	80.19%	35.73%	17.99%	29.28%	58.51%
All years	78.04%	37.65%	17.64%	29.35%	64.74%
Panel B. Firms that did not repurchase shares					
2010	88.51%	73.76%	18.95%	30.69%	
2011	110.33%	105.25%	57.39%	71.17%	
2012	110.89%	73.48%	27.84%	38.17%	
2013	116.62%	73.39%	-10.53%	-1.31%	
2014	145.21%	79.28%	-25.92%	-14.17%	
2015	121.77%	64.11%	-6.85%	6.85%	
2016	113.32%	82.13%	16.54%	27.22%	
2017	114.07%	72.54%	25.18%	37.03%	
All years	115.44%	77.50%	11.59%	23.12%	

Gross investment (GI) is defined as the sum of capital expenditures net of capital asset sales, acquisitions net of divestitures, and research and development expense; Net new debt financing (Debt) is defined as the proceeds from the issuance of debt net repayments of debt; net new capital (Cap) is the sum of net new debt plus new equity capital; new equity capital is defined as the sum of the proceeds from the issuance of common stock the issuance of preferred stock, and the sale of treasury shares; ordinary dividends (Div) are defined as payments of dividends to common stock; total cash payouts (pay) are the sum of ordinary dividends and the amount paid to repurchase common stock; adjusted net income (NI) is defined as the sum of reported net income, depreciation expense, and research and development expense. All estimates are winsorized at the 1-percentile and 99-percentile levels.

Statement by

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Testimony before the House Financial Services Committee
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets

Hearing on
"Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors"

October 17, 2019

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

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[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

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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

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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

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[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 incentives[51] 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]

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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—Japan[79] 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.

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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.

QFRs for the October 17, 2019, hearing of the HFSC Subcommittee on Investor Protection on "Examining Corporate Priorities: The Impact of Stock Buybacks..."

Representative Chuy Garcia

Questions to be answered by witnesses Jesse M. Fried, Derik D. Coffey, and Dr. Craig Lewis

1. Do you recognize that the profits that a company retains are the foundation for investment in innovative capabilities? If you disagree, what is your view of how firms finance investments in innovative capabilities?

   Firms finance innovation and investment through (a) retained earnings, (b) debt financing, and (c) equity financing. A firm that has generated and retained profits will likely use retained earnings to finance innovation and investment. Most younger firms, on the other hand, do not have retained earnings to finance innovation and investment; they typically rely at least partially on equity financing. That is why public firms not big enough to be in the S&P 500 are net importers of equity capital: they directly or indirectly raise more cash from shareholders than they distribute via buybacks and dividends.

2. Do you recognize that, when employees work hard and smart to help a company generate innovative products, they have valid claims to share in profits in the form of higher wages, better benefits, and more employment security?

   I believe that employees have a claim to whatever they bargain for; their contracts should be respected. Employees can and do bargain for pay arrangements that are tied to firm profits. Employees can and do bargain for more employment security. And employees can and do bargain for better benefits.

3. One witness stated that wages are determined by supply and demand in the labor market, so that workers get paid according to the marginal productivity of labor. Why then has there been a widening gap between productivity growth and wage growth in the US economy since the late 1970s?

   I am not an expert in labor economics, and thus unfortunately unequipped to answer the question.

4. It was stated by two witnesses that it is when the market undervalues a company, and hence its stock price is unduly low, that a share repurchase will take place. Why then does the evidence show that most buybacks are affected when stock prices are high?

   My research with Professor Charles Wang of Harvard Business School indicates that buybacks are, on average, "underpriced": the stock price turns out to be low relative to the future stock price. That said, there are many situations where buybacks are "overpriced": the price turns out to be high relative to the future stock price. There are many reasons why such "overpriced" buybacks occur. However, it's important to remember that, from the perspective of all public investors, an overpriced buyback is not by itself undesirable: it simply transfers value from non-selling public investors to selling public investors, without changing the amount of value shared by public investors as a group.

5. Securities laws do not permit fraud or other forms of market manipulation, even if such actions by companies would raise share prices. Why then should the SEC give a safe harbor against manipulation charges to a company engaging in open-market repurchases, even though the company's purpose is plainly to manipulate the market price of its stock?

   While repurchases can be used to mechanically manipulate the stock price by exerting price pressure on the stock, I doubt most repurchases have this intent or effect. Unfortunately, current disclosure rules prevent us from knowing the extent to which such manipulation occurs.

   The two-day disclosure rule I have put forward, which would require firms to disclose details of repurchases within two days, would make such manipulation observable and, by doing so, likely reduce the extent of manipulation.

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Questions to be answered by witnesses Jesse M. Fried, Derik D. Coffey, and Dr. Craig Lewis

1. Do you recognize that the profits that a company retains are the foundation for investment in innovative capabilities? If you disagree, what is your view of how firms finance investments in innovative capabilities?

I agree with this statement.

2. Do you recognize that, when employees work hard and smart to help a company generate innovative products, they have valid claims to share in profits in the form of higher wages, better benefits, and more employment security?

I believe that employees are entitled to receive fair compensation for their labor. A firm has no obligation to pay more than a fair wage simply because it is profitable.

3. One witness stated that wages are determined by supply and demand in the labor market, so that workers get paid according to the marginal productivity of labor. Why then has there been a widening gap between productivity growth and wage growth in the US economy since the late 1970s?

This question is outside of my area of expertise.

4. It was stated by two witnesses that it is when the market undervalues a company, and hence its stock price is unduly low, that a share repurchase will take place. Why then does the evidence show that most buybacks are affected when stock prices are high?

I am not sure what you are asking here. Just because stock prices are high, doesn't Imply that individual stocks could not be undervalued. The empirical evidence is consistent with the observation that buyback firms are undervalued.

5. Securities laws do not permit fraud or other forms of market manipulation, even if such actions by companies would raise share prices. Why then should the SEC give a safe harbor

> against manipulation charges to a company engaging in open-market repurchases, even though the company's purpose is plainly to manipulate the market price of its stock?

To establish manipulation, one would need to demonstrate that the price was artificially high. To do this, it is necessary to show that an action caused prices to temporarily increase and then revert to previous levels. Since price increases following the announcement of a buyback do not revert, buybacks are inconsistent with manipulation.