October 11, 2019

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: October 17, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing Entitled: "Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment"

On Thursday, October 17, 2019 at 10:00 a.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment." Witnesses for the hearing are:

- **Jesse M. Fried**, Professor of Law, Harvard Law School
- **Lenore Palladino**, Senior Economist and Policy Counsel, Roosevelt Institute
- **Janie Grice**, United for Respect at Walmart
- **Derik D. Coffey**, CFA, Portfolio Specialist, Channing Capital Management

Additional witnesses may be added.

Background

A stock buyback is a corporate capital allocation decision that occurs when a company purchases its own stock, typically in the open market.[1] Prior to 1982, stock buybacks were perceived to be illegal — a company purchasing its own stock tends to artificially and temporarily drive up the company's stock price — thus exposing companies to accusations of illegal market manipulation.[2] As a result, prior to 1982, companies primarily returned capital to shareholders by paying cash dividends.[3]

In 1982, the Securities and Exchange Commission (SEC) promulgated Rule 10b-18, which creates a safe harbor from liability for manipulation under sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") for companies engaging in stock buybacks.[4] In order to take advantage of

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[1] While open market purchases are the most common form of buybacks, companies can also conduct buybacks through tender offers and privately negotiated purchases.
[2] *See* SEC, PURCHASES OF CERTAIN EQUITY SECURITIES BY THE ISSUER AND OTHERS, 75 Fed. Reg. 4713 (Jan. 29, 2010) ("Because issuer repurchases could affect the market price of an issuer's stock, an issuer may be exposed to claims that the repurchases were made in a manipulative manner even when the repurchases were not intended to move market prices.").
[3] *See* Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases, and the Substitution Hypothesis*, 57 J. FIN. 1649, 1655 (2002) (finding that between 1972 and 1983, dividends accounted for 80% to 90% of cash payouts).
[4] *See* 17 C.F.R. § 240.10b-18.

the safe harbor in Rule 10b-18, companies must abide by manner, timing, price, and volume conditions that are intended to minimize the impact that such buybacks have on the company's stock price.[5] Companies are required to disclose any purchases of their own stock in their quarterly and annual reports.[6] In addition, when a company publicly announces a stock buyback plan or program, SEC rules require the company to include certain details of the plan or program in the announcement, including the amount of shares to be repurchased and the expiration date for the plan or program.[7] Rule 10b-18 has not been updated since 2003, when total stock buybacks were less than 20% of the current level.[8]

Buybacks vs. Dividends

While buybacks and dividends both return capital to shareholders, there are critical differences between these two methods. After a company buys back its own shares, there are necessarily fewer total shares of the company outstanding. This has wide-ranging effects, including temporarily inflating earnings per share. Dividends, on the other hand, don't reduce the number of shares outstanding.

Further, when a company pays a cash dividend for a given class of shares, *all* holders of that class of shares receives a cash payment. When a company engages in a stock buyback program, however, only the shareholders who choose to sell their stocks back to the company receive a cash payment. Importantly, this means that the tax treatment of stock buybacks and dividends differs as well. For buyback programs, only the shareholders who sell their stock back to the company are required to pay capital gains taxes on their individual gains.[9] For dividends, all shareholders are required to pay taxes on the dividend, either at the ordinary income tax rate or (more typically) at the capital gains tax rate.[10] Thus, buybacks are considered a more tax-efficient way of returning capital to shareholders.[11]

The Growth of Buybacks

In 1980, before the SEC promulgated Rule 10b-18, U.S. companies only repurchased $6.6 billion of their own stock, and 89% of payouts to shareholders took the form of dividends.[12] However, the total amount of stock buybacks has increased dramatically in recent years — and particularly after the passage of the Tax Cut and Jobs Act of 2017 (TCJA), which lowered the corporate tax rates and allowed U.S. companies to repatriate offshore profits at a temporarily lower tax rate.[13] In 2018, after the TCJA was

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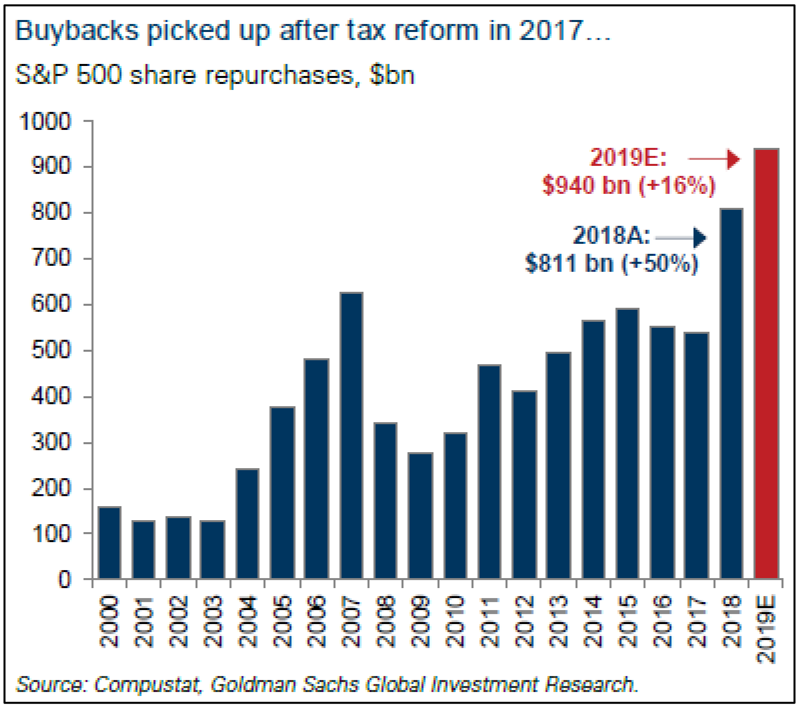
[5] *Id.*
[6] *See* Item 2(c) of Form 10-Q; Item 5(c) of Form 10-K.
[7] *See* Item 703 of Regulation S-K.
[8] *See* Goldman Sachs, *Top of Mind: Buyback Realities*, at 5 (April 11, 2019).
[9] *See* Internal Revenue Service, *Publication 550, Investment Income and Expenses* (Mar. 29, 2019), *available at* https://www.irs.gov/pub/irs-pdf/p550.pdf.
[10] If a shareholder hasn't held the stock for more than 60 days during the 121-day period before the date of the dividend, then the dividend is considered an ordinary dividend, and the shareholder must pay the ordinary income tax rate. If the shareholder *has* held the stock for more than 60 days during that 121-day period, then the dividend is considered "qualified," and the shareholder can pay the lower capital gains tax rate. *Id.* at 19.
[11] *See* Jesse M. Fried, *Informed Trading and False Signaling With Open Market Repurchases*, 93 Cal. L. Rev. 1323, 1336 (October 2005) (noting that "[h]istorically, repurchases have been a much more tax-efficient means of distributing excess cash than dividends.").
[12] *See id.* at 1335.
[13] *See* P.L. 115–97 (2017).

signed into law, stock buybacks at U.S. companies jumped roughly 50% from 2017, to a record $811 billion.[14] Stock buybacks are estimated to rise even further in 2019, to roughly $940 billion.[15]



Criticisms of Buybacks

Use of Excess Cash

Because companies use excess cash to repurchase shares in a buyback program, the rise in stock buybacks has been criticized as coming at the expense of other uses of excess corporate cash, such as increasing worker wages, or investing in new equipment or R&D.[16] This criticism has become especially vocal in the wake of the TCJA, where an estimated 40-60% of corporate tax savings have been spent on buybacks, while wage growth for workers has remained stagnant.[17]

Transparency

In addition to the criticisms surrounding the practice's effect on employee wages, there are also significant concerns related to a lack of transparency around stock buybacks. When companies announce

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[14] Goldman Sachs, *Top of Mind: Buyback Realities*, at 5.
[15] *Id.*
[16] *See e.g.*, William Lazonick, *Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute*, BROOKINGS INITIATIVE ON 21ST CENTURY CAPITALISM (April 2015), *available at* https://www.brookings.edu/wp-content/uploads/2016/06/lazonick.pdf; Andy Green, Christian Weller, and Malkie Wall, *Corporate Governance and Workers: Why Today's Economy Fails Working Families — And What To Do About It*, at 5 (August 14, 2019), *available at* https://cdn.americanprogress.org/content/uploads/2019/07/13064340/Corporate-Governance1.pdf (noting that "a range of commentators have expressed concerns that excessive buybacks are squeezing out investments in the future and diverting resources from the interests of other company stakeholders.").
[17] *See* Federal Reserve Bank of Atlanta, *Wage Growth Tracker*, *available at* https://www.frbatlanta.org/chcs/wage-growth-tracker.aspx.

buyback programs, they are not required to disclose whether executives at the company plan to participate in the buyback program. Moreover, companies are not required to actually carry out the buyback programs they announce, nor are they required to immediately disclose the transactions that occur as part of a buyback program to the SEC, which makes it difficult for the SEC to supervise these programs and invites potential abuse.

Executives' Conflicts of Interest

Executives at public companies are often paid in stock, in order to align the incentives of the executives and the companies' shareholders.[18] One way for executives who are paid in stock to monetize such stock-based compensation is to approve a stock buyback program, and then sell the stock they have received as part of their compensation back to the company in the buyback program.[19] In fact, a study conducted by SEC Commissioner Robert Jackson found that executives at public companies sold up to five times as much stock as usual immediately following a buyback announcement, suggesting that executives may be abusing this practice for personal gain.[20]

Moreover, empirical evidence has shown that executives announce stock buyback programs that they do not intend to execute in order to increase the company's stock price, which allows the executives to sell their own stock in the open market at artificially inflated prices.[21]

Legislative Proposals

H.R. 3355: Reward Work Act (Rep. Garcia): This bill would repeal SEC Rule 10b-18, and would prohibit all public companies from engaging in open-market stock buybacks. However, the bill would not prohibit companies from buying back their own stock through tender offers (as long as the tender offers comply with the SEC's rules on tender offers), or through privately-negotiated purchases. In addition, the bill would require at least one-third of the directors at every publicly traded company to be chosen by the company's employees, through a vote that takes place on a "one employee, one vote" basis. The SEC, in consultation with the National Labor Relations Board (NLRB), would be required to promulgate rules to ensure that such director elections are "fair and democratic."

H.R. ____: Stock Buyback Reform and Worker Dividend Act: This bill converts SEC Rule 10b-18 from a safe harbor to a prohibition on excessive stock buyback activities, lowers the permissible amount of stock buybacks for public companies, and creates new reporting requirements for companies that do engage in stock buybacks. Further, the bill requires public companies to reward their workers if they reward their shareholders by issuing a "worker dividend" that will be equal to $1 for every $1 million spent on stock buybacks, dividend increases, and special dividends.

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[18] *See e.g.*, Kevin J. Murphy, *Executive Compensation: Where We Are and How We Got There*, in GEORGE CONSTANTINIDES, MILTON HARRIS, AND RENE STULZ, EDS., HANDBOOK ON ECONOMICS AND FINANCE 211 (2013).
[19] *See* Commissioner Robert Jackson, *Stock Buybacks and Corporate Cashouts* (June 11, 2018), *available at* https://www.sec.gov/news/speech/speech-jackson-061118 ("Researchers have long worried that executives, who always prefer cash to stock, will try to sell rather than hold their shares, eliminating the incentives they were meant to produce.").
[20] *Id.*
[21] *See* Fried, *Informed Trading and False Signaling With Open Market Repurchases*, at 1353–1356.

H.R. ____: To amend the Securities Exchange Act of 1934 to require issuers to disclose to the SEC the details of any repurchase plan for an equity security, to prohibit such a repurchase unless it is approved by the Commission, and for other purposes: This bill would repeal SEC Rule 10b-18, and would instead require public companies to file with the SEC, at least 15 days prior to the commencement of a stock buyback program, detailed information about worker wages, layoffs at the company, a description of the company's pension plan, and how the buyback plan serves the long-term interests of all of the company's stakeholders, including employees, customers, and shareholders. After reviewing the company's filing, the bill further requires the SEC to approve or deny the company's buyback plan.

H.R. ____: Stock Buyback Disclosure Improvement Act: This bill would require public companies, when they announce a stock buyback program, to disclose whether executives at the company plan to participate in the buyback program. In addition, the bill would require companies, when they announce a buyback plan, to disclose how the buyback plan will affect the compensation, or elements used to determine the compensation, of the company's executives.