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Meridian Client Update

Corporate Share Repurchase Programs Draw Increasing Criticism

Since 2009, corporate share repurchase programs have been a ubiquitous feature of many public companies' capital allocation strategies. Generally, these programs have been applauded by institutional shareholders, while raising little concern by other parties. That dynamic is now changing with share repurchase programs drawing sharp criticism from politicians, state and union pension funds, and others.

Recently, politicians, the media, academics and governance experts have criticized company stock buyback programs as a mechanism for enriching shareholders and executives through short-term boosts in a company's stock price, while harming employees and misallocating capital to the detriment of the long-term financial interests of companies.¹ Calls for reform have intensified as the use of share repurchase programs has significantly increased from 2017 through the first quarter of 2019, since the enactment of the Tax Cuts and Jobs Act of 2017, although more recent data suggests the rate of increase is moderating.

To remedy these claimed excesses, some investors and politicians are calling for reform of the SEC's share buyback rules. In particular, a group of investors led by the AFL-CIO and CtW Investment Group have petitioned the SEC to revise Rule 10b-18, which governs share repurchase programs. In addition, some Democratic presidential candidates and other legislators have proposed various reforms of these rules. This Client Update reports on these reform efforts.

Background on Rule 10b-18

Broadly, federal securities laws prohibit a party (or group acting in concert) from manipulating the price of a publicly traded security for the party's advantage.² A stock repurchase program could potentially expose a company to allegations of market manipulation. To avoid this possibility, in 1982, the SEC adopted Rule 10b-18, which provides a public company a "safe harbor" from liability for market manipulation when the company repurchases its own stock on the open market in accordance with the rule's manner, timing, price and volume conditions. However, the safe harbor "is not available for repurchases that, although made in technical compliance with the [section 10(b) of the Exchange Act], are part of a plan or scheme to evade the federal securities laws."

Investor Group Petitions the SEC to Eliminate Rule 10b-18

In its petition to the SEC, the investor group initially made the sweeping claim that the share repurchase safe harbor "has failed to meet the purpose behind its promulgation: limiting the ability of [a public company] to

¹See, e.g., Jesse M. Fried and Charles C. Y. Wang. "The Real Problem With Stock Buybacks." *The Wall Street Journal*. July 6, 2018. Available at: <https://www.wsj.com/articles/the-real-problem-with-stock-buybacks-1530903118>. See also, Nell Minow. "Stock Buybacks Often Second-Worst Option." *The Wall Street Journal*. July 12, 2019.

²Section 9(a)(2) of the Securities and Exchange Act ("Exchange Act") makes it unlawful for a party (or a group acting in concert) trading in securities to create actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. Generally, Section 10(b) of the Exchange Act and SEC Rule 10b-5 prohibit manipulative and deceptive practices in securities trading.

manipulate its stock price and volume.” The investor group further claims that despite the safe harbor, public companies “retain the ability to artificially inflate stock prices or meet performance goals through repurchases that benefit executives without corresponding improvements to the real value of the [company]. This manipulative redirection of capital comes in part at the expense of American workers.”

In its petition to the SEC, the investor group raised the following specific concerns about stock repurchase programs and Rule 10b-18:

- Stock buybacks drain funds available for employee compensation and capital investment.
- Rule 10b-18 does not address the strong financial incentive of executives to use the effects of share repurchase programs to increase their compensation.
- Rule 10b-18 does not require effective public disclosure of share buyback programs, which obscures whether these programs comply with the safe harbor conditions.

To curb these claimed excesses, the investor group has requested that the SEC eliminate the share buyback safe harbor and adopt a new rule that establishes a comprehensive framework for regulating stock buyback programs.

Legislative Proposals on Reforming Stock Buyback Programs

The investor group’s petition follows calls by a number of politicians for legislation revisiting the share buyback rules. As described in [our Client Update dated June 17, 2019](#), the Democratic-controlled House of Representatives Financial Services Committee has developed draft legislation that would direct the SEC to evaluate whether share buyback programs are abusive and determine if future rulemaking is required to curb such abuses.

Several Democratic Senators and one Republican Senator have introduced/proposed legislation that would revise the share buyback rules and/or create a ‘worker dividend’ intended to ensure workers receive a fair share of the profits they help create.³ In February 2019, Senators Charles Schumer and Bernie Sanders wrote a *New York Times* Op-Ed announcing their plan to introduce legislation that would prohibit a corporation from buying back its stock unless it “invests in workers and communities first”, including paying all workers at least \$15 an hour, providing seven days of paid sick leave and offering decent pensions and more reliable health benefits.⁴

Shortly thereafter, Republican Senator Marco Rubio released a proposal to curb share repurchase programs by taxing share buybacks like dividends and allowing companies to immediately write off capital expenditures and R&D expenses.⁵ Under Senator Rubio’s plan, any cash spent by companies on buybacks would be considered, for tax purposes, a dividend paid to shareholders. This means that each shareholder would be deemed to have received a portion of this dividend based on the shareholder’s percentage ownership of a company’s outstanding common stock.

In addition, in a June 2018 letter to SEC Chair Jay Clayton, 21 Senate Democrats requested, in light of the accelerating pace of stock buybacks, that he review how companies and executives are using the buyback

³ For example, Sherrod Brown introduced the Stock Buyback Reform and Worker Dividend Act of 2019 (S. 2391), Tammy Baldwin introduced the Reward Work Act (S. 915), and Corey Booker introduced the Worker Dividend Act of 2018 (S. 2505 (115th)).

⁴ “Schumer and Sanders: Limit Corporate Stock Buybacks.” *The New York Times*. February 3, 2019. Available at <https://www.nytimes.com/2019/02/03/opinion/chuck-schumer-bernie-sanders.html>.

⁵ Laura Davidson. “Rubio Wants to Curb Stock Buybacks Encouraged by 2017 Tax Law.” *Bloomberg*. February 12, 2019.

process and solicit public comment regarding the stock buyback rules.⁶ The letter indicates that both Commissioner Peirce and the Chair himself had previously indicated support for a review of Rule 10b-18.⁷

Meridian Comment

We do not expect the SEC to act upon the investor group's petition at this time given the SEC's current priorities and rulemaking backlog. However, Chair Clayton's and Commissioner Peirce's prior comments in support of a review of Rule 10b-18 suggest that share buyback programs may become the focus of SEC scrutiny and/or a subject of future rulemaking.

Currently, the various legislative proposals make for good political and campaign fodder. Under the current administration, the passage of any of these proposals is highly unlikely. Of course, the status quo may change after next year's presidential election if the Democrats win back the White House and the Senate (and retain control of the House). A Democratic-controlled Congress could pass legislation requiring the SEC to review its current share buyback rules or directly amend the Exchange Act to alter the playing field for share buyback programs and impose other obligations on public companies that wish to implement or continue share buyback programs.

Use of financial metrics based on per share measurement (most commonly, earnings per share (EPS)) is a significant minority practice among large public companies in short-term and/or long-term incentive programs. These metrics may be impacted by share repurchase programs. Compensation committees should consider the effect of an active, planned or larger than budgeted share buyback program on incentive payouts linked to achievement of EPS goals. Compensation Committees may wish to consider adopting a policy or guidelines on whether to neutralize the effect of a share buyback program on incentive payouts either through (i) setting EPS goals that are automatically adjusted to take into account share buybacks or (ii) adjusting achieved EPS results at the conclusion of the performance period. However, even if a company has no plans to adjust EPS goals or achieved EPS performance for share buyback activity, Compensation Committees should nonetheless understand the magnitude of the effect of the share buybacks on actual EPS results.

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⁶ Available at [https://www.baldwin.senate.gov/imo/media/doc/Senators Letter to Clayton on Buyback Rules FINAL.SIGNED.6.28.18.pdf](https://www.baldwin.senate.gov/imo/media/doc/Senators%20Letter%20to%20Clayton%20on%20Buyback%20Rules%20FINAL%20SIGNED%206.28.18.pdf).

⁷ The letter cites Commissioner Peirce's statement during her confirmation process that, in her view, "a review of Rule 10b-18 would be 'timely' given the increase in buyback activity" and that she looked forward to working with her fellow Commissioners and the SEC staff "to look at the evidence about how and why buybacks are occurring and assess whether, in light of this evidence, changes to the regulatory framework are needed." Similarly, the letter notes that, at a Senate Banking Committee hearing last year, Chair Clayton stated, "one thing that does trouble me is if these stock buybacks are motivated not by the long-term interest of the company but some short-term interest."