The $1 Trillion Question: New Approaches to Regulating Stock Buybacks

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Stock buybacks—transactions in which public companies buy back their own equity securities on the open market—are on track to reach $1 trillion in 2018. Such repurchases manipulate the market price for issuer securities. They represent a choice by firms to prioritize shareholder payouts over other uses of corporate funds, contributing to widening economic inequality. Currently, stock buybacks are regulated by the Securities and Exchange Commission's Rule 10b-18, a "safe harbor" rule that does not ameliorate market manipulation. This Essay recommends a new regulatory regime, outlining several alternative approaches to ensure the integrity of capital markets and corporate productivity.

Introduction

Stock buybacks[1] by America's public companies are on track to hit $1 trillion in 2018.[2] Stock buybacks are regulated by the Securities and Exchange

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1. Stock buybacks are known by a variety of terms, including issuer repurchases and open-market share repurchases. All refer to the same activity.

2. Jeff Cox, *Companies Set to Buy Back $1 Trillion Worth of Shares This Year, and That Should Keep Market Afloat, Goldman Says*, CNBC (Aug. 6, 2018, 11:01 AM), https://www.cnbc.com/2018/08/06/companies-set-to-buy-back-1-trillion-worth-of-shares-this-year-to-kee.html [https://perma.cc/VE5J-BBW2].

Commission's Rule 10b-18 (the "Rule"),[3] but the Rule has not stopped a surge in buyback activity. In the recent hearings for Securities and Exchange Commissioner nominees, two future Commissioners agreed that they would be open to a fresh look at the Rule.[4] More recently, Commissioner Robert Jackson Jr. followed up on this commitment and called for an open comment period on the Rule in response to a major increase in the dollar volume of stock buybacks.[5] This Essay argues that it is past time to take a fresh look at the policies that govern stock buybacks and examines the range of policies available to rein in this practice.

Rule 10b-18 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 Rule allows for firms to conduct virtually unlimited stock buybacks, impacting the market in contravention of the spirit of Section 10b of the Securities and Exchange Act.[6] The conditions concern the volume, manner, price, and timing of repurchases, and disclosure is required on quarterly reports. The justification for the Rule is to ensure that companies would not face liability for market manipulation for conducting buybacks. But the regulatory approach of Rule 10b-18 is broken. The original purpose behind the regulatory regime, "a scheme of regulation that limits the ability of an issuer . . . to control the price of the issuer's securities,"[7] is not met by Rule 10b-18's framework or the enforcement approach the Commission has taken.

Beyond their impact on stock price, stock buybacks matter because they contribute to widening economic inequality. Corporations face an opportunity cost when allocating funds to shareholder payouts rather than to increasing employee compensation, funding retained earnings that are the foundation of firm growth, or investing in future productivity.[8] This tradeoff is in part a result of incentives for corporate insiders to conduct buyback programs for their own personal profit.

I argue that there are two regulatory paths available: the Securities and Exchange Commission could adopt an entirely new regulatory regime for stock

3. 17 C.F.R. 240.10b-18 (2018).

4. Both Commissioner Robert Jackson Jr. and Commissioner Hester Pierce responded affirmatively to a question posed by Senator Brian Schatz as to whether they would be willing to reconsider the Rule. *See Nominations of David J. Ryder, Hester M. Peirce, and Robert J. Jackson, Jr.: Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs,* 115th Cong. 34 (2017).

5. Commissioner Robert J. Jackson Jr., Speech at the Center for American Progress: Stock Buybacks and Corporate Cashouts (June 11, 2018), https://www.sec.gov/news/speech/speech-jackson-061118 [https://perma.cc/CBP3-ASWG].

6. Securities and Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2018).

7. Purchases of Certain Equity Securities by the Issuer and Others, 45 Fed. Reg. 70,890 (Oct. 27, 1980).

8. For a full discussion of the relationship between stock buybacks and employee outcomes, see generally Lenore Palladino, *Stock Buybacks: Driving a High-Profit, Low-Wage Economy*, ROOSEVELT INST. (Mar. 20, 2018), http://rooseveltinstitute.org/stock-buybacks-high-profit-low-wage [https://perma.cc/4HKX-X3CJ].

buybacks, or Congress could enact new legislation that would either ban or seriously constrain the practice. Congress can enact legislation that restricts repurchases outright; conditions repurchases according to another set of corporate variables; or places a tax on such transactions in order to disincentivize the behavior. Alternatively, the Securities and Exchange Commission can repeal Rule 10b-18 and replace it with new regulations that either revert to the pre-1982 status for buybacks, or create new regulations in line with other advanced economies: rules that place bright-line limits on the volume, manner, price, and timing of repurchases; mandate immediate disclosure; prohibit insider sales of their own holdings within a certain time period after a repurchase program; and put a new governance process in place for the initiation of repurchase programs. This Essay will describe and evaluate each of these policies with respect to the three core harms of stock buybacks: the potential for stock price manipulation, opportunity costs for other uses of corporate funds, and the perverse incentives for insiders to sell their own shares for personal gain.

This Essay proceeds in two Parts. Part I outlines the problems with stock buybacks and Rule 10b-18, both substantive and in terms of corporate governance. Part II first presents a landscape of other regulatory models and then proposes several paths forward for regulation.

I. The Problems with Stock Buybacks

In this Part, I describe why stock buybacks are justified by a "shareholder primacy" approach to the firm. I will then briefly describe their rise in dollar volume and the categories of harm: their effect on stock price; their relationship to broader economic inequality; and their incentive structure for corporate executives. Finally, I examine the flaws of Rule 10b-18's regulatory approach.

A. Justifications for Stock Buybacks

Driving the practice of stock buybacks is the "shareholder primacy" corporate legal framework. This theory claims that shareholders are the "owners" of a firm and 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.[9] The idea that shareholders are a firm's owners—the primary risk-takers because they invest capital with no guarantee of return, and thus the residual claimants of its wealth, popularized by Michael Jensen and Milton Friedman—is, according to corporate law scholar Lynn Stout, based on a misunderstanding of corporate law.[10] Shareholders do not own "the firm"—

9. *See* Kent Greenfield, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 1 (2006).

10. Lynn A. Stout, *The Shareholder Value Myth* 3 (Cornell Law Faculty Publ'n No. 771, 2013), https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=2311&context=f

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,[11] as well as the right to bring a claim for a breach of fiduciary duty.[12] Other scholars claim that, regardless of whether or not shareholders "own" the firm, under the Delaware General Corporation Law ("DGCL"), maximizing shareholder wealth is the fiduciary duty of corporate boards of directors.[13]

Though its basis in corporate law is contested, shareholder primacy dominates business practices today, and justify widespread use of stock buybacks. The premise of stock buybacks is that shareholders should be "returned" this available cash when it has not found another productive use.[14] This framework itself gives rise to two reasons to question stock buybacks. First, even if we accept the primacy of shareholders in corporate law, stock buybacks primarily benefit short-term shareholders who sell their stock after the price goes up, rather than longer-term shareholders who want corporations to invest in future productivity to ensure a long-term rising share price, not dependent on the company's repurchase of its own shares. Even under shareholder primacy, corporations have variable needs for funds to ensure long-term growth, and we can see that stock buybacks constitute an opportunity cost for further investment, employee compensation, or even the build-up of reserves.[15]

The second problematic framework for repurchases has to do with the theory of the interaction between finance and the real economy. Defenders of repurchases argue that buybacks serve an important function by reallocating capital to where it would be most useful.[16] Under this theory, when executives determine that they have no investment opportunities where the rate of return is above the cost of capital, they should logically return the cash to shareholders, who will invest the funds in companies that do have investment opportunities

acpub [https://perma.cc/YT3W-Z3SH] (discussing the rise of the ideology of shareholder primacy and its critical flaws as a matter of law).

11. *Id.*

12. 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*, INSTITUTE FOR NEW ECONOMIC THINKING, Working Paper No. 77 (2018).

13. *See, e.g.*, DAVID YOSIFON, CORPORATE FRICTION: HOW CORPORATE LAW IMPEDES AMERICAN PROGRESS AND WHAT TO DO ABOUT IT (2018).

14. For a full discussion of the 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].

15. There are important reasons to question whether shareholder primacy is the most useful approach to corporate law normatively, but those considerations are outside the scope of this paper.

16. *See, e.g.*, Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows* (Harvard Bus. Sch. Accounting & Mgmt. Unit Working Paper No. 17-062, European Corp. Governance Inst. (ECGI)- Law Working Paper No. 342/2017, Feb. 9, 2017), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Fried_897.pdf [https://perma.cc/78YS-NT5L].

that are profitable to pursue. One problem with this argument is that the majority of shares are bought and sold on the secondary market, meaning that very little of the funds from a shareholder purchasing shares make their way back into a firm's coffers. Firms have to issue new equity in order to directly benefit from any purchase of their stock. This points to a larger misunderstanding about the purpose of the stock market historically: that the primary reason companies issue shares has been to raise cash. Instead, shareholders primarily buy and sell stocks with each other, raising the value of shares without directly raising available funds for companies.

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.[17] Firms have large stocks of cash with which to conduct internal financing. Interest rates for corporate borrowing are historically low.[18] And most importantly for evaluating stock buybacks, net issuances in the non-financial corporate sector have been negative for every year since 1997, sometimes sharply so.[19] This means that more equity is pulled out of the market through buybacks than is created through new issuances. Even though buybacks could in theory be an efficient way for capital to be reallocated between companies with publicly-traded stock, the evidence does not show that this is occurring.

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, especially executives. It could be that shareholders are taking the gains from buybacks and investing in private firms, but there is a decline in the rate of business startups in the economy.[20] Wealthy shareholders may also be investing in large private companies, but the use of buybacks to transfer wealth from public to private companies means that the majority of investors, who are non-accredited investors, will be locked out of the potential for wealth appreciation.[21] The problems with buybacks have magnified as the dollar volume has grown, particularly as companies (outside of the financial sector) have spent more on

17. *See id.*

18. *See, e.g.*, *Moody's Daily Corporate Bond Yield Averages*, https://fred.stlouisfed.org/series/AAA [https://perma.cc/QN4Z-WMCE].

19. *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. 68 tbl.F-223 (Sep. 20, 2018, 12:00 PM ET), https://www.federalreserve.gov/releases/z1/20180920/z1.pdf [https://perma.cc/BAT4-4JKE]; *see also* Palladino, *supra* note 8. In the financial sector, new equity issuances ballooned after the financial crisis because banks issued new equity to the U.S. 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 14.

20. Mike Konczal & Marshall Steinbaum, *Declining Entreprenurship, Labor Mobility, and Business Dynamism: A Demand-Side Approach*, ROOSEVELT INST. (July 21, 2016), http://rooseveltinstitute.org/wp-content/uploads/2016/07/Declining-Entrepreneurship-Labor-Mobility-and-Business-Dynamism-A-Demand-Side-Approach.pdf [https://perma.cc/VP76-8T25].

21. This is not an argument to remove limits on investing in private markets, because doing so risks increasing the negative impact of the hype and even fraud that takes advantage of limited disclosure requirements.

shareholder payouts than they had available in profits. Stock buybacks have grown from $469 million in 1979 to $748 billion in 2016.[22] Projections for 2018, following the adoption of the TCJA, posit that repurchases could top $1 trillion for the first time[23]. In many industries repurchases exceeded profit in multiple years.[24]

B. The Harms of Stock Buybacks

What are the specific harms of stock buybacks? I describe several types of harm as a result of stock buybacks. The first is their potential to manipulate stock price, in violation of Section 9(a)(2) of the Exchange Act. The second is the opportunity cost that they represent for other uses of corporate profits, from long-term investment to improvements in employee compensation. Finally, and perhaps the biggest driver of repurchases, is their perverse incentives on executives and other insiders who are compensated in stock in order to tie their personal motivations to firm outcomes to instead sell their shares. A distinct harm is the lack of accountability under Rule 10b-18 and the lack of other constraints on stock buybacks.

First, and most simply, repurchases may be used to manipulate stock prices because the very nature of buying back stock means that the remaining shares rise in value.[25] Though the question of whether trading activity alone can be considered manipulation remains contested, and the legal framework for manipulation "lacks precision, cogency, and consistency of application,"[26] large volumes of stock buybacks undoubtedly move securities prices, and before 1982 left firms open to liability for market manipulation. 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). Rule 10b-18 enables firms to conduct buybacks, within its timing,[27] volume,[28] price,[29] and manner conditions[30] (although there is no assumption of liability if buybacks happen outside those conditions), so that, in theory, repurchases 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

22. Author's analysis of data from S&P Compustat (on file with author).
23. Cox, *supra* note 2.
24. Author's analysis of data from S&P Compustat (on file with author).
25. What constitutes market manipulation legally is complex. *See generally* Merritt Fox et al., *Stock Market Manipulation and Its Regulation*, 35 YALE J. ON REG. 67 (2018); *see also* William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (Sept. 2014), https://hbr.org/2014/09/profits-without-prosperity [https://perma.cc/53WG-TAGR] [hereinafter *Profits Without Prosperity*] (describing the rise of stock buybacks and their role in corporate investment decisions).
26. Fox et al., *supra* note 25 at 71.
27. 17 C.F.R. 240.10b-18(b)(2) (2018).
28. 17 C.F.R. 240.10b-18(b)(4) (2018).
29. 17 C.F.R. 240.10b-18(b)(3) (2018).
30. 17 C.F.R. 240.10b-18(b)(1) (2018).

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.[31] 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.[32]

A second harm of stock buybacks is their impact on wealth and income inequality. In terms of wealth inequality, stock buybacks only benefit those who hold stock. Less than half of households own any stock at all, and less than a third of households own at least $10,000 worth of stock.[33] Stock ownership is concentrated at the top of the wealth distribution: 93% of households in the top one percent of households by income own more than $10,000 of stock.[34] Stock ownership reflects broader racial stratification as well: while approximately 60% of white households own stock either directly or indirectly, only 34% and 30% of Black and Latino households, respectively, hold stock.[35] All of this means that increasing stock value driven by stock buybacks disproportionately benefits wealthier families. Stock buybacks are also an opportunity cost for other uses of corporate funds, and their rise correlates with a long-term decline in corporate investment.[36] If corporations redirected funds spent on buybacks to employee compensation, wage increases could lift low-income workers out of poverty.[37]

Another harm is the incentives created for corporate insiders, particularly executives. Only corporate insiders know about buybacks when they are actually conducted; disclosure comes after the fact. Corporate executives hold large amounts of stock and their compensation is often tied to an increase in the company's earnings per share (EPS) metric. That gives executives a personal incentive to time buybacks so that they can profit off of a rising share price.[38] That means that the decision of whether and when to execute a stock buyback

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31. *See generally* Fox et al., *supra* note 25.

32. Heitor Almeida et al., *The Real Effects of Share Repurchases*, 119 J. FIN. ECON. 168 (2016).

33. EDWARD WOLFF, A CENTURY OF WEALTH IN AMERICA 125 (2017).

34. *Id.* at 127.

35. Lisa J. Dettling et al., *Recent Trends in Wealth-Holding by Race and Ethnicity: Evidence From the Survey of Consumer Finances*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Sep. 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 [https://perma.cc/6ZS7-KJBQ].

36. J.W. Mason, *Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment*, ROOSEVELT INST. (2015), http://rooseveltinstitute.org/wp-content/uploads/2015/09/Disgorge-the-Cash.pdf [https://perma.cc/8FCT-A4BJ].

37. See Lenore Palladino, *Making the Case: How Ending Walmart's Stock Buyback Program Would Help to Fix Our High-Profit, Low-Wage Economy*, ROOSEVELT INST. (2018), http://rooseveltinstitute.org/making-case [https://perma.cc/CN8E-DSQH].

38. *See* Jackson, *supra* note 5.

can affect his or her compensation by tens of millions of dollars. Recent research by SEC Commissioner Robert Jackson Jr. found that the likelihood of insiders selling shares increased five-fold in the week after the announcement of a repurchase program.[39] 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.

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.[40] 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.[41] Further, executives are required to disclose the monthly volume of actual open-market repurchases, but only after the fact.[42] 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.

A distinct set of problems with stock buybacks is the lack of oversight as to whether companies are staying within the limits of Rule 10b-18. Stock buybacks that are higher than the safe harbor's volume limits would, in theory, be subject to action by the SEC for market manipulation. However, assumptions of liability are not automatic even when the safe harbor is exceeded. Because the data is not actually collected as to whether or not a company's buybacks are within the daily safe harbor limits or not (data is reported by month rather than by day),[43] and is not required to be collected, it is impossible for the Commission to bring such actions, and thus all stock buybacks are protected from charges of market manipulation. In response to a letter from Senator Tammy Baldwin in 2015, then-SEC Chair Mary Jo White said, "because Rule 10b-18 is a voluntary

39. *Id.*

40. 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].

41. *Id.*

42. 17 C.F.R. 229.703 (2018).

43. *Id.*

safe harbor, issuers cannot violate this rule."[44] To date, the SEC has not investigated companies for violating the daily limit because "performing data analyses for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is not currently available."[45] There have been only two enforcement actions related to Rule 10b-18.[46] As it stands today, Rule 10b-18 has been insufficient to curb the harms of stock buybacks.

II. A New Regulatory Regime for Stock Buybacks

In this Part, I outlined the path forward for new regulation. In Part II, Section A, I give a broad landscape of regulatory alternatives from two sources: first, earlier rules proposed by the Commission that preceded Rule 10b-18 and differed significantly; and second, rules from a variety of international jurisdictions. In Section B, I develop more specificity to the new rules that the Commission could promulgate. In Section C, I outline new legislative approaches that could be complementary to new Commission rules.

A. A Landscape of Regulatory Alternatives

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)[47] and 10(b)[48] of the Act and its promulgating Rule 10b-5.[49] 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,[50] 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

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44. *See* David Dayen, *SEC Admits It's Not Monitoring Stock Buybacks to Prevent Market Manipulation*, THE INTERCEPT (Aug. 13, 2015, 9:08 AM), https://theintercept.com/2015/08/13/sec-admits-monitoring-stock-buybacks-prevent-market-manipulation [https://perma.cc/6RW9-NDQ5].

45. *Id.*

46. Email from Steven G. Johnston, Special Counsel, the Office of Investor Education and Advocacy, Securities and Exchange Commission (June 19, 2018) (on file with author); *see also* Incomnet, Inc., SEC Release No. 40281 (July 30, 1998), https://www.sec.gov/litigation/admin/3440281.txt [https://perma.cc/89CN-3JJV]; SEC v. Wachovia Corp., SEC Litigation Release No. 18958 (Nov. 4, 2004), https://www.sec.gov/litigation/litreleases/lr18958.htm [https://perma.cc/L2DN-RQPV].

47. 15 U.S.C. § 78i (2018).

48. 15 U.S.C. § 78j (2018).

49. 17 C.F.R. 240.10b-5 (2018).

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

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."[51]

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.[52] 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 fifteen percent of the average daily trading volume in the four calendar weeks preceding the week in which the buybacks were conducted.[53] These same conditions, with the volume increased by ten 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.[54]

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."[55] 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."[56] 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

51. *Id.*

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

53. *Id.*

54. *Id.* at 11412.

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

56. *Id.*

dispose of the issuer's securities they might presently hold."[57] 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.[58]

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."[59] Such a need "stems in part from the unique incentives[60] that an issuer . . . [has] to control the price of the issuer's securities."[61] The Commission explained that the guidance was intended to help issuers avoid securities law liability that they could not otherwise predict, since the antifraud and anti-manipulative provisions of the Act are general in nature.[62] 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."[63] Again the Commission left room for a case-by-case exemption of transactions that otherwise would exceed the proposed Rule.[64]

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.[65] 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.[66] 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

57. *Id.* at 34342.

58. 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.

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

60. 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.*

61. *Id.*

62. *Id.*

63. *Id.* at 70891.

64. *Id.* at 70896.

65. *Id.*

66. *Id.* at 70898.

manipulative to the market.[67] 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."[68]

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.[69] 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."[70] 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.[71] The purpose of Rule 10b-18 instead was to facilitate repurchases and limit intrusive regulation into corporate decision-making.[72]

It is useful to be aware of how stock buybacks are regulated 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.[73] To summarize, the significant differences from the U.S. 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.[74] Many countries follow the U.S. model with restrictions on timing, price, volume, and manner. Among the ten countries with the largest capital markets, all others place clear limits on repurchase activity, and most have more specific repurchase requirements.[75] In the United Kingdom, approval is required at a shareholder meeting, not just from the board of directors.[76] Open market share repurchases must be reported immediately to the Financial Supervisory Authority, and disclosure of volume and price is required.[77] Requirements put in place by the Tokyo Stock Exchange restrict repurchases in terms of price, quantity and timing, and disclosure is required on

67. *Id.* at 70897.

68. *Id.*

69. 17 C.F.R. 240.10b-18 (2018).

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

71. *See id.* at 995.

72. *See id.*

73. *See* Jaemin Kim, Ralf Schremper & Nikhil Varaiya, *Survey on Open Market Repurchase Regulations: Cross-Country Examination of the Ten Largest Stock Markets*, 9 CORP. FIN. REV. 29 (2005).

74. *Id.*

75. *Id.*

76. *Id.* at 32.

77. *Id.*

execution at the close of the trading day.[78] 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.[79]

In European Union member states, approval at a shareholder meeting is also required, and the authorization is valid for eighteen months.[80] In France, significantly, the regulatory agency (the Commission des Operations de Bourse) must also approve the program.[81] In Italy, shareholders must also approve the maximum number of shares to be acquired and the minimum and maximum purchase price.[82] There is a bright-line limit that a firm cannot buy back more than 10% of outstanding shares in France, Germany, Italy, Switzerland, and the Netherlands.[83] E.U. countries require repurchases to be made out of distributable profits, i.e., not purchased with debt.[84] 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 ten days after the end of each month. Repurchasing firms must also disclose whether insiders plan to sell their holdings during the firms' buyback program.[85] 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 completed, a firm must immediately make a public announcement.[86] Several countries also disallow buybacks within ten days prior to earnings announcements.[87]

B. New Rules at the Securities and Exchange Commission

Rule 10b-18 has not stopped the tremendous growth in stock buybacks. Additionally, because the Commission does not track whether companies are complying with the conditions of the Rule, there is virtually no accountability for potential market manipulation. In order to address the narrower potential problem of market manipulation and the wider problems of the social role of the corporation and widening economic inequality, a new regulatory regime is required.[88]

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78. *Id.* at 32.
79. *Id.*
80. *Id*. at 35.
81. *Id*. at 32.
82. *Id*. at 34.
83. *Id.*
84. 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.
85. *Id.* at 33.
86. *Id.* at 34.
87. *Id.*
88. Though critics may say curbing buybacks will simply lead companies to raise dividends, proper regulation of buybacks will limit the potential for insider incentives, and promote

There are a variety of new rules that could be promulgated by the Commission to curb repurchases. The Commission can issue new rulemaking to again allow for companies to be held liable for open market share repurchases as market manipulation, in violation of Section 10(b) of the Securities and Exchange Act, pursuant to the authorization given to it by the Williams Act Amendment of 1968, § 2(e)(1). This would return essentially stock buybacks to pre-1982 regulation, in which the potential for liability led companies to largely avoid buybacks. Another approach is to place a bright-line limit on the dollar amount of buybacks that a company can conduct. The Commission places many bright-line limits on companies' securities offerings pursuant to the 1933 and 1934 Acts.[89] A bright-line rule prohibiting companies from conducting repurchases over certain limits would have the effect of lowering the potential for market manipulation, while leaving room for repurchases at the lower level.

In the alternative, the Commission could decide that it must authorize a company's use of stock buybacks and could promulgate rules giving it wide latitude to reject buybacks that come at the expense of other corporate stakeholders. As proposed by Senators Baldwin and Schumer in an amendment to the 2018 banking reform bill, the Commission would have the authority to require detailed disclosure of buyback plans and execution, reject buybacks plans, and require boards and the CEO to certify that the buybacks are in the long-term "best interest" of the company.[90] Elements of the above approaches were in the proposed Rule 13e-2 versions from the 1970s.

Alternately, the Commission could focus on corporate governance rather than substantive limitation, and could require that disinterested directors only authorize repurchase programs, or that companies must meet financial benchmarks to conduct repurchases. In the United Kingdom, a public company can only use distributable profits or the proceeds from a fresh share issuance to conduct a repurchase.[91] Insiders could also be either prohibited from trading during repurchase programs or at least required to disclose such plans. As discussed above, boards and executives face conflicting incentives when authorizing stock buybacks. In many of the countries with the largest stock market capitalization—Japan, France, Canada, the Netherlands, Hong Kong, and the United Kingdom—there are explicit restrictions on trading by insiders during a period of buyback activity. For example, Japan delegates the setting of guidelines to the Tokyo Stock Exchange, which requires that "an insider who is

increased attention to long-term corporate profitability, as dividends benefit shareholders while buybacks benefit share-sellers.

89. *See generally* 17 C.F.R. 230.501 (2018) (rules defining dollar thresholds for accredited investors).

90. *See U.S. Senator Tammy Baldwin and Senate Democratic Leader Chuck Schumer Introduce Amendment to Rein in Corporate Stock Buybacks in Banking Deregulation Bill*, OFFICE OF SENATOR TAMMY BALDWIN (Mar. 7, 2018), https://www.baldwin.senate.gov/press-releases/amendment-to-rein-in-corporate-stock-buybacks [https://perma.cc/CDB4-847Q].

91. Companies Act 2006, c. 46 (Eng). The Act covers England and Wales; Scotland; and Northern Ireland.

in a position to make a firm's share repurchase decisions should not trade his own holdings of the firm's shares while a buyback program is underway."[92] In France, monthly disclosure is required to the state agency regulating the stock market (the Commission des Operations de Bourse).[93] In Canada and the Netherlands, proactive disclosure is required if interested individuals are planning to sell their holdings during the course of a repurchase program.[94] The Commission could put both limitations on insider selling of shares and immediate disclosure requirements in place.

General company disclosure requirements, though not sufficient to curb substantive behavior, would at minimum inform the Commission when bright-line rules are violated, and put directors and officers on notice that repurchase activity will be scrutinized in real time. As noted above, other countries like Japan and the United Kingdom mandate daily disclosure of repurchases. Former Chair Mary Jo White stated that the Commission did not have the data necessary to tell when the Rule was violated.[95] Perhaps the simplest solution of all would be to require firms to disclose repurchases immediately and publicly, as is required in several countries. It is certainly within the technological capabilities of firms and the Commission to collect and immediately disclose daily data.

C. Congressional Approaches to Reining in Stock Buybacks

Congress can take steps that the Commission cannot. Congress can ban open market share repurchases by passing affirmative legislation that prohibits purchases by an issuer of its own equity on the national securities exchanges. Such legislation was proposed by Senator Tammy Baldwin in the "Reward Work Act," which adopts this prohibition and additionally gives Rule 10b-18 "no force or effect."[96] Another approach, similar to what was proposed above for the Commission, is to limit the volume or other conditions for repurchases to a bright-line rule. The rationale behind these policies is that the main purpose of buybacks is to increase the price per share without an increase in real productivity inside the firm. In other words, shares are supposed to rise in value as companies become more profitable, though efficiencies, increased market share, more customers, etc. An increase in share price purely driven intentionally by a reduction in the number of shares on the market is out of step with larger social values that Congress seeks to uphold.

Congress could choose 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

92. Kim, *supra* note 73 at 32.
93. *Id.*
94. *Id.* at 33 – 34.
95. Dayen, *supra* note 44.
96. The Reward Work Act of 2018, H.R. 6096, 115th Cong. (2018).

commensurate with company spending on stock buybacks.[97] 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 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.

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. Financial transaction taxes are a broad category of taxes that applies small levies on financial transactions, analogous to sales taxes for transactions of goods and services.[98] Such taxes are common globally and have historically been used in the United States. Financial transaction taxes serve to raise revenue but also dampen the trading volume of whatever financial asset is being traded because they take a percentage of profits per trade. They can be structured in a variety of ways on a variety of financial assets, from a very low basis point level that would likely serve to only reduce the lowest-margin trading, to higher rates that would affect trading volume significantly.

In this case, the relevant policy is to institute a stock buyback transaction tax, in which each stock buyback transaction costs the firm a certain percentage of the dollar value of the trade in taxes. Critics of transaction taxes often claim that the tax would serve to dampen market liquidity and lower trading volume; in this case that would be the purpose of the tax. Revenue would be a secondary consideration. 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.[99]

Conclusion

The volume of stock buybacks suggests that such repurchases have the potential to lead and dominate the entire market for that issuer's securities. Rule 10b-18 has both substantive and democratic flaws in its implementation and is not an effective mechanism to appropriately curb issuer repurchasing behavior.

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

98. Wall Street Trading and Speculators Tax Act of 2011, H.R. 3313, 112th Cong. (2011).

99. For the relevant literature on financial transaction taxes and their effect on stock trading volume, see generally Robert Pollin et al., *The Revenue Potential of a Financial Transaction Tax for U.S. Financial Markets*, POL. ECON. RESEARCH INST. (2017), https://www.peri.umass.edu/publication/item/698-the-revenue-potential-of-a-financial-transaction-tax-for-u-s-financial-markets [https://perma.cc/MR8P-353N]. For additional analysis on the effects of a stock buybacks transaction tax, unpublished research is on file with the author.

Two paths are available for updated regulation: the Commission could repeal Rule 10b-18 and replace it with a regime in which companies are again subject to liability for market manipulation if appropriate; bright-line substantive rules with true enforcement capabilities; or promulgate new processes for ensuring that insiders cannot benefit from buybacks and that decisions to conduct buybacks are made in the true best interest of the company. Alternately, Congress could create new statutes to ban repurchases as impermissible, tax repurchases to dampen activity, impose rules where firms cannot conduct repurchases without meeting other criteria for corporate behavior, or impose governance requirements so that shareholders and disinterested parties authorize repurchase activity. In order to ensure that capital markets are not manipulated by tremendous repurchase activity and that firms undertake true innovative enterprises that sustain prosperity, a new regulatory regime is required.