Congressional Research Service
Informing the legislative debate since 1914

IN FOCUS

April 16, 2020

Stock Buybacks and Company Executives' Profits

A *stock buyback* occurs when a publicly traded firm repurchases some of its shares from investors with excess cash or borrowed funds. In recent years, the annual aggregate value of such repurchases has risen to historical highs, reaching nearly $1 trillion as firms, such as Apple, Exxon Mobil, Microsoft, IBM, Visa, Citigroup, Cisco, Pfizer, Oracle, and Bank of America, have conducted billion-dollar-plus stock repurchases. As aggregate buyback levels have soared, general scrutiny of them has intensified.

The scrutiny also appears to have heightened after the 2017 tax revision (P.L. 115-97) was enacted. This tax legislation resulted in overall corporate tax cuts that increased surplus corporate cash, which in turn led to significant increases in buybacks at various firms.

Legislation related to buybacks has been introduced in the 116th Congress. S. 915 and H.R. 3355 would prohibit a firm from conducting a buyback. S. 2391 would ban buybacks unless they were accompanied by new buyback disclosure reforms. S. 2514 and H.R. 4419 would levy a tax on companies that did not distribute a worker "dividend" from their profits. The dividend's size could be based on the size of the company's recent stock buyback. As part of broad private equity fund reform, S. 2155 and H.R. 3848 would prohibit firm buybacks in which a private equity fund has acquired a controlling interest.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) bars certain eligible firms that receive Department of the Treasury loans from conducting buybacks for the loan's duration plus a year afterward.

Some observers have central concerns that buybacks (1) represent a problematic short-term oriented use of firm assets at the expense of longer-term investments; (2) can be exploited by senior executives for personal financial gain; and (3) are often debt-financed, which can boost a firm's vulnerability.

Others, however, emphasize that buybacks (1) can help signal that a company's stock is undervalued; (2) are often used to offset share dilution after new stock is issued to facilitate stock- and stock option-based employee compensation programs; (3) represent the most financially prudent use of a company's excess cash to finance itself; (4) represent shareholders reinvesting cash proceeds to boost capital formation; and (5) have arguably buoyed the past decade's bull stock market.

Background

A firm's net income (also called net profit) is the remaining cash after operating expenses, interest, and taxes are deducted from its revenue. It is also the funding source for voluntary quarterly distributions to shareholders known as dividend payments. A firm may also use its net income to buy back or repurchase its shares on the open market (the secondary stock market where shares are traded). Stock reacquired via a buyback is called treasury stock, which is either permanently removed from stock-market circulation or retained by a company to be resold in the future.

Some publicly traded firms may choose not to pay dividends or conduct buybacks; some may conduct a buyback and pay dividends during the same period; and others may do one but not the other. A buyback and a dividend are similar in the sense that they both involve redistributing cash to shareholders. Dividends, however, have a much longer history and tend to represent an ongoing commitment to shareholders that firms may be reluctant to overlook for fear of sending a negative signal to securities markets. Firms are not generally expected to continue buybacks year after year.

Aggregate dividend payments previously generally surpassed buybacks in size. By the late 1990s, the aggregate annual size of stock buybacks generally exceeded that for dividend payments. As indicated earlier, buyback scrutiny appeared to have heightened after the 2017 tax revision. After the reforms went into effect, historically robust dividend payments ensued, but the significant increases in stock buybacks received more media attention.

Regulation 10b-18

In 1982, the Securities and Exchange Commission (SEC), which regulates equity market trading, adopted Rule 10b-18 that provides companies with a legal safe harbor during a stock buyback program. Rule 10b-18 ensures firms that repurchase stock generally would not be subject to legal liability for manipulation under the Securities and Exchange Act of 1934 (P.L. 73-291) if the volume of daily stock buybacks does not exceed 25% of the previous four weeks' average daily trading volume in company stock. By various accounts, in the years soon after Rule 10b-18 went into effect, there was significant growth in buybacks, which are annually dominated by a few large well-capitalized firms. According to Reuters, between 2010 and 2014, 60% of the approximately 4,000 publicly traded nonfinancial U.S. companies conducted buybacks.

Earnings Per Share and Buybacks

Several decades ago, many publicly traded firms' top executives began receiving a significant amount of their compensation in the form of long-term-incentive (LTI) pay, which is long-term compensation designed to incentivize executives to perform in ways to help achieve a firm's strategic objectives, purportedly better aligning their interests with those of shareholders. LTI pay tends to be

dominated by company stock-based compensation, including stock options (securities that allow the option holder the right to buy or sell shares of a certain stock at a specified price for a specified period of time); stock grants (stock that cannot be sold by their recipients until a certain amount of time has transpired, the vesting period); and restricted stock (stock awards that are subject to certain conditions, including employment for a defined period of time, and the firm's fulfillment of certain financial performance goals). By various accounts, mainstreaming the LTI component of executive pay has led to an unprecedented growth in the size of senior executive pay packages at publicly traded firms.

Executive pay packages, which are formulated by corporate boards, often make the receipt of such LTIs dependent on a company's success at satisfying certain annual financial metrics, a major one being earnings per share (EPS). An indicator of profitability, EPS is the part of a company's profit allocated to the outstanding number of shares of common stock.

In general, when an executed stock buyback removes outstanding company shares, the EPS's denominator falls; earnings are then divided by a smaller amount and the EPS increases. Thus, buybacks can boost a company's EPS, which is frequently employed as an executive compensation metric. The stock market's reaction to the reduced supply, however, may be somewhat offset by its reaction to the forgone interest on the cash that was used in the buyback to repurchase stock.

Stock buyback plans, which generally extend several years, and sometimes are not implemented, are promulgated by senior executives, including the CEO, and then authorized by a company's board. When announcing whether implementing a buyback is intended, firm managers—poised to sell corporate shares—may be trying to replicate the aforementioned stock market price impact of an actual buyback, according to Harvard Law School Professor Jesse Fried. The mere announcement of a stock buyback may result in a transient rise in share price.

Some observers, such as Harvard Business School's William Lazonick, have raised concerns that senior executives are self-interestedly motivated to conduct buybacks to help inflate the EPS. Others, however, argue that the alleged connections between buybacks, EPS, and executive pay are tenuous.

For example, David Kostin, chief of research at Goldman Sachs, found that in 2018, S&P 500 index firms' senior executives whose pay was tied to EPS devoted a lower proportion of their total cash spending to buybacks than did firms in the index whose senior executive pay was not linked to EPS (28% to 32%, respectively). The findings, Kostin argued, help to dispel the notion that executives repurchase stocks solely to boost EPS to meet their compensation targets.

Former SEC Commissioner Robert Jackson's Research

In 2018, former SEC Commissioner Robert J. Jackson's staff conducted an extensive study of how executives appeared to have exploited their firm's buyback announcements in 2017 and part of 2018. The commissioner noted that an announced buyback tends to convey management's view that firm shares were undervalued and generally resulted in a temporary uptick in share price of about 2.5% in the ensuing days. His staff found that after companies announce buybacks, an unusually large number of senior executives sold their corporate shares during subsequent days. Specifically, the staff found that during the eight days after an announced buyback, individual executives on average sold more than $500,000 worth of stock per day; however, they sold an average of less than $100,000 daily of company stock during the days before such announcements. (Some firms prohibit such stock sales.)

On the implications of the findings, the commissioner observed,

> 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. [T]he evidence [also] shows that buybacks give executives an opportunity to take significant cash off the table, breaking the pay-performance link [compensation agreements that tie executive pay to measures of corporate performance.]

One observer, *Fortune* magazine's Shawn Tulley, did not question the integrity of Commissioner Jackson's research or findings. He did, however, raise some questions about the relative significance of the findings. He noted that public company CEOs and other senior managers tend to receive the vast majority of their compensation through restricted shares and stock options, observing that those financial instruments generally take four years or more before they are tradeable. As a consequence, Tulley argued that the staff's research lacked a meaningful comparison between the size of the buyback-based executive stock selloffs and the size of what he called the "trove" of executive stock options and restricted stock grants that executives typically have at any point in time and cannot trade.

Gary Shorter, Specialist in Financial Economics

IF11506

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.