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The SEC's New Repurchase Disclosure Rules

A Solution in Search of a Problem?

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DIVIDENDS AND SHARE REPURCHASES are the two ways for companies to provide a payout to their shareholders. Finance research going back more than half a century has repeatedly confirmed that management teams prefer stable dividends. Once they increase dividends, they are very reluctant to lower them.

On the other hand, management teams view repurchases as a more flexible method to provide a payout to their shareholders. In 2023, S&P 500 companies are expected to repurchase more than $1 trillion worth of their own shares. But share repurchases are much more volatile. For example, during the Global Financial Crisis, dividends increased from $528 billion in 2008 to $553 billion in 2009, whereas repurchases dropped from $511 billion in 2008 to only $201 billion in 2009. Dividends are favored by large, profitable corporations with stable cash flows. Repurchases are favored by corporations large and small with volatile cash flows.

On May 2, the US Securities and Exchange Commission (SEC) by a 3-2 vote adopted new disclosure rules related to corporate share repurchase programs. The new rules require repurchasing corporations to disclose daily repurchasing activity on a quarterly basis; this information needs to be tabulated in the 10-Q or 10-K filings. Previously, repurchasing corporations were required to disclose monthly repurchasing activity on a quarterly basis. Additionally, repurchasing corporations now must indicate via a checkbox whether any of their officers or directors engaged in buy or sell trades within four days of the public announcement of a share repurchase.

Part of the impetus for these rules are concerns that share repurchases enable managers to sell the shares they have received as incentive compensation at inflated prices. However, the following simple and transparent executive compensation plan would allow companies to address this regulatory concern about share repurchases in a more substantive manner.

The incentive compensation of senior corporate executives should consist primarily of restricted equity (i.e., restricted stock and restricted stock options). "Restricted" in this sense means that the individual cannot sell the shares or exercise the options for six to twelve months after their last day in office. Under this restricted equity compensation plan, most incentive compensation would be driven by total shareholder returns, instead of short-term accounting-based measures of performance such as return on capital or earnings per share. The rationale for having restrictions for six to twelve months after the executive's departure is to eliminate perverse incentives for executives to make self-interested decisions during the "end game" immediately prior to retirement. In particular, this delay would eliminate incentives for executives to engage in share repurchases just to sell their vested shares at an artificially inflated share price immediately after retirement.

It is important to note that if corporate boards had adopted the above incentive compensation plan for their senior executives, the occurrence of

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many of the current (Silicon Valley Bank) or past (Enron Corp., Qwest Communications, big banks circa 2008) governance failures would have been much less likely. The proximate causes of these governance failures are different: asset-liability duration mismatch for Silicon Valley Bank, difficulty in valuing complex securities for the big banks in 2008, and misrepresentation of future revenue growth at Enron and Qwest. However, the common denominator across these governance failures is misaligned executive incentive compensation that encouraged senior executives in these companies to engage in behavior that led to their downfall.

Does a share buyback add "real" value? The short answer is yes. First, by repurchasing their own company's shares, managers send a credible signal that they think their shares are currently undervalued in the market. The market response to repurchases is positive and remains positive a year out.

Second, share buybacks are a corporate governance tool that reduces agency costs between managers and outside shareholders. Companies that have excess free cash flow can either pay it out to their shareholders or invest it internally in value-destroying projects. (Excess cash flow is defined as cash flow left over after a company has funded all positive net present value projects.) Hence, paying out the excess free cash flow is in the best interest of outside shareholders. Retaining it allows management to invest it in current or future pet projects, which also grows the company size—a variable highly correlated with executive compensation. This has important policy implications; the SEC's new repurchase disclosure rules make repurchases more costly for companies, thereby encouraging these companies to cut back on their repurchases and invest their free cash flow internally in value-destroying projects.

Would share repurchases not crowd out corporate research and development (R&D) and capital investments? This time, the short answer is no. Researchers at the Massachusetts Institute of Technology have documented that companies that engage in repurchases invest less than companies that do not. (Investment is measured as R&D plus capital investment, scaled by total assets.) Additionally, these researchers found that companies that engage in repurchases tend to be quite profitable, while those that do not typically have losses. This suggests that profitable firms repurchase shares while maintaining a steady level of investment, whereas less profitable or loss-making firms do not repurchase shares since they do not have the financial resources to do the repurchases.

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Similar to the above argument, critics of corporate repurchases suggest that increasing costs on repurchases would encourage corporations to invest more internally in real assets with an accompanying increase in their number of employees and products. However, a decrease in repurchases does not automatically lead to an increase in real corporate investment activity; these corporations could easily invest in financial assets (which, on an after-tax basis, are negative net present value investments for the company's shareholders).

The SEC's new repurchase disclosure rules also require repurchasing companies to provide a narrative explaining the objectives or rationales for the repurchase plan, the criteria used to determine the amount of repurchases, and the policies relating to purchases and sales of their securities by their officers and directors during a repurchase program, including any restrictions on such transactions. The SEC is rightly concerned that some companies might use boilerplate language to address the narrative requirement, and has suggested that by providing relevant contextual information they could address the boilerplate narrative concern. Examples of contextual information include the following:

- Other possible ways to use the funds allocated for the repurchases, such as capital expenditures and other uses of capital
- The expected impact of the repurchases on the value of remaining shares
- Factors driving the repurchases, including whether companies' stock is undervalued

These SEC suggestions are constructive, and corporate boards should advise managers to heed this guidance.

Most corporate managers use repurchases as an integral part of their investment, financing, and payout strategies. Share repurchases do create shareholder value. The SEC's new repurchase disclosure rules could benefit from a critical review since they do not benefit investors or other corporate stakeholders. D