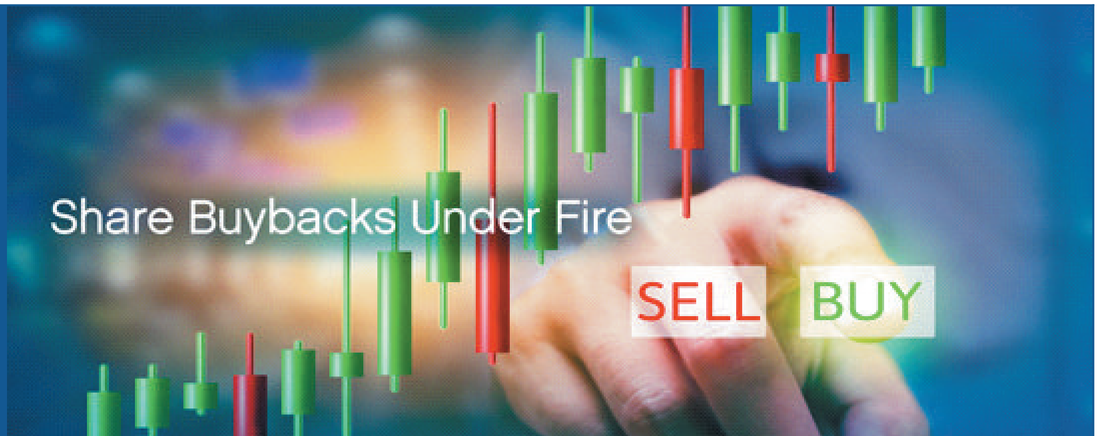
JONES DAY

GOVERNANCE PERSPECTIVES

APRIL 2019



IN SHORT

The Background: Corporate share buybacks have skyrocketed in today's low interest rate environment, and the trend is likely to continue.

The Issue: Although stock buybacks are an efficient method to return cash to shareholders, they have come under attack in some quarters—and there are several legislative efforts underway to regulate or curtail them.

The Outcome: Federal legislation to regulate stock buybacks would be unwise and seems unlikely. Companies and their boards should, however, be aware of the emerging criticism of buybacks—and practices that may help overcome the criticism.

Stock buybacks reached record levels in recent years, fueled in part by the 2017 tax cuts, shareholder activism, and record low borrowing costs. S&P 500 companies repurchased a record $770 billion in shares in 2018, and forecasts for 2019 are even higher, with companies expected to repurchase $940 billion—using almost a third of the aggregate $3 trillion in cash reflected on the balance sheets of the S&P 500.

Stock buybacks have, however, been sharply criticized of late and have been ensnared in the bitter partisanship in Washington. For example, Senators Schumer and Sanders penned an op-ed in *The New York Times* outlining a plan to limit buybacks to companies that pay workers at least $15 an hour and provide paid sick time. Others have advocated for restrictions on executives' abilities to sell their shares following a buyback announcement or to require additional disclosure about the board's reasons for choosing a share repurchase. Are these criticisms justified, or have buybacks been targeted unfairly?

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One of the chief arguments against buybacks is that companies that repurchase shares are using capital for a short-term purpose—returning cash to shareholders—at the expense of long-term goals, such as R&D, capital improvement, and worker training. In fact, some companies have used this "short-termism" argument to resist demands by shareholder activists to implement substantial returns of capital.

Capital allocation decisions are, however, far more complicated than many buyback critics admit. In certain circumstances, particularly when interest rates are low and/or the company has a cash surplus, a company's investment in its own shares may be the most efficient near-term use of capital for the company and its shareholders. Cash returned to shareholders can be reinvested in companies with different growth profiles or capital needs, efficiently allocating capital across the economy. Moreover, there is no compelling evidence that share repurchases ultimately result in decreased cap ex spending or negatively impact long-term growth, as for most companies dividends and other returns of capital are but one component of a company's overall capital allocation strategy.

Another criticism of buybacks is that they unfairly enhance executive pay. Of course, share repurchases boost earnings per share, and may increase share prices, at least in the short-term. When incentive compensation packages are based in part on those metrics, critics may claim that buybacks are unfairly enriching executives. It is our sense, however, that these criticisms based on the purported impact of buybacks on employee pay are misguided.

While they sometimes are opportunistic, buybacks are part of a company's overall capital allocation policy in most cases, and compensation targets are set with this in mind. Moreover, buybacks generally have a positive impact on share prices which, of course, benefits all shareholders, not just executives or employees. Finally, some of the legislative efforts to regulate and improve transparency about buybacks identify a problem that has already been solved—the SEC's current disclosure requirements already cover all that is needed.

A related point, however, is how the buyback boom should affect executive compensation decisions on a more basic level. The overall trend to align shareholder and management interests has resulted in very substantial increases in the percentage of top management (and even directors) being made in the form of equity rather than cash.

However, in an era in which stock buybacks are substantial and consistent, it at least raises the question whether it makes sense for companies to pay employees in equity when they are buying back stock—and have been for years. Companies with large-scale repurchase programs may consider whether general changes to compensation practices are warranted—such as more sharply targeting the people in the equity pool, putting hold requirements on stock awards, adopting (or readopting) vesting restrictions and using phantom equity, which on the whole, are practices that are otherwise becoming less prevalent.

As with most governance issues, there is no one-size-fits-all approach here. Moreover, the decision of how to best allocate capital is, of course, squarely within the purview of the board. Although buybacks may have a short-term impact, that is precisely the kind of investment decision the board is expected to make—how to allocate the company's capital among short- and long-term uses and opportunistic or strategic goals.

In our view, severely restricting repurchases—or limiting them to companies that have adopted specific employment practices—may be an inapt, or even pernicious, way to address concerns relating to share buybacks and may have an unintended impact on the economy as a whole, and Congress has more important topics on which to focus than this.

TWO KEY TAKEAWAYS

1. Corporate share buybacks remain at record high levels, although they have been sharply criticized and have spurred possible federal legislation curbing their use.

2. Capital allocation decisions—including the return of capital to shareholders through dividends or repurchase programs—are squarely within the purview of the board of directors. Directors should, however, be sensitive to the criticisms lodged against share buybacks when designing and implementing a repurchase program.


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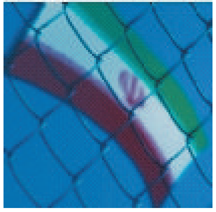

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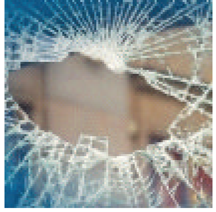

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