COMMITTEE ON CAPITAL MARKETS REGULATION

Short-termism, Shareholder Activism and Stock Buybacks

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Short-termism, Shareholder Activism and Stock Buybacks

Executive Summary

According to the short-termism thesis, public companies in the United States are excessively focused on increasing short-term stock prices and are therefore foregoing valuable long-term investment. We evaluate the evidence to support the short-termism thesis including the role of shareholder activism and stock buybacks by public companies.

The first section of the report focuses on the empirical literature addressing whether short-termism exists, the potential causes of short-termism, and the economic effects of short-termism, if any. We find that U.S. public companies engage in similar amounts of long-term investment as private companies and public companies' long-term investment has increased substantially in recent years. We therefore do not find support for the contention that short-termism is a problem in U.S. markets.

We then consider the rise of shareholder activism, which refers to tactics employed by shareholders of a company that are aimed at increasing the value of their stake in the company. Shareholder activism is often identified as a *cause* of short-termism as presumably these shareholders are focused on short-term returns. This section focuses primarily on the empirical literature related to shareholder activism by hedge funds, which typically includes aggressive tactics, such as proxy fights aimed at replacing a company's board of directors. Overall, we find that hedge fund activism confers positive benefits on firms in the short run and the evidence regarding activism's long-term effects is mixed.

The third section of the report considers the rise in stock buybacks by public companies. A stock buyback is a firm repurchasing its own previously issued stock from shareholders and is a method, along with dividends, for firms to redistribute excess capital back to shareholders. Critics of stock buybacks argue that the recent rise in stock buybacks is a *symptom* of short-termism—an attempt by companies to boost their stock prices in the near term, while foregoing long-term investment. However, we describe a number of motivating factors for stock buybacks that are not short-term, including increased flexibility of buybacks as compared to dividends and lowering a firm's cost of capital. We also review empirical literature finding that stock buybacks often do not increase short-term stock prices and that long-term investment is particularly strong at companies engaged in share buybacks.

The final section of the report sets forth the Committee's policy recommendations to enhance long-term investment in U.S. public markets. First, we recommend that U.S. public companies weigh carefully the costs and benefits of issuing quarterly earnings guidance and consider ending the practice if they determine that such guidance is discouraging long-term investment. Second, the SEC should issue guidance clarifying that, when a company's Board of Directors authorizes a stock repurchase program, the company should disclose on a timely basis certain material elements of the program, including its approximate intended duration and the maximum approved repurchase amount (for example, as a total number of shares or a total dollar value). Public companies should disclose these material elements within five business days of the authorization of the repurchase plan, through a press release or other Reg FD-compliant method that ensures broad public dissemination.

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1. The short-termism debate

Though the debate on whether short-termism afflicts public companies goes back one hundred years, politicians continue to sound the short-termism alarm. For example, in 2016, then Vice President Joe Biden wrote that "[s]hort-termism…is one of the greatest threats to America's enduring prosperity."[1] During her presidential campaign, Hilary Clinton also took aim at the alleged short-term focus of public companies, and called for legislation aimed at countering "hit and run" activist shareholders.[2] Republican Senator Marco Rubio has similarly criticized corporations' focus on short-term returns to shareholders, which he argues is "devastating for American workers, and in the long term it's devastating for America,"[3] and stresses that since the 1970s "changes made by American businesses and policymakers began prioritizing high returns to investors in the short term, rather than investment in long-term capabilities."[4] In a report titled "American Investment in the 21st Century" he noted that "[w]e need to build an economy that can see past the pressure to understand value-creation in narrow and short-run financial terms, and instead envision a future worth investing in for the long-term."[5]

Despite this political narrative, prominent legal and economic scholars have often concluded that there is little to no evidence of a short-termism problem in U.S. public markets. Harvard Law School Professor Mark Roe argues that "the proponents of stock-market-driven short-termism have not yet

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[1] Joe Biden, *How Short-Termism Saps the Economy*, Wall Street Journal (Sep. 27, 2016), available at https://www.wsj.com/articles/how-short-termism-saps-the-economy-1475018087.

[2] See Jonathan Allen and Luciana Lopez, *Clinton proposes tax, buyback changes to encourage long-term growth*, Reuters (July 24, 2015), available at https://www.reuters.com/article/us-usa-election-clinton/clinton-proposes-tax-buyback-changes-to-encourage-long-term-growth-idUSKCN0PY26N20150724. Short-termism has also been highlighted as a matter of global concern. The World Economic Forum included short-termism among its five leadership priorities in 2017. Also, in 2017, the United Nations Global Compact issued a report in 2017 providing strategies and recommendations for managing market short-termism. See Klaus Schwab, *Five Leadership Priorities for 2017*, World Economic Forum (Jan. 2017), available at https://www.weforum.org/agenda/2017/01/five-leadership-priorities-for-2017/; Principles for Responsible Investment and United Nations Global Compact, *Coping, Shifting, Changing 2.0: Corporate and investor strategies for managing market short-termism* (2017).

[3] James Hohmann, *The Daily 202: Marco Rubio slams CEOs for bad China deals, short-term thinking and not investing in U.S. workers*, Washington Post (May 15, 2019), available at https://www.washingtonpost.com/news/powerpost/paloma/daily-202/2019/05/15/daily-202-marco-rubio-slams-ceos-for-bad-china-deals-short-term-thinking-and-not-investing-in-u-s-workers/5cdaf5841ad2e544f001dd1a/.

[4] Marco Rubio, *We need to invest in America again*, Washington Examiner, (May 13, 2019, available at https://www.washingtonexaminer.com/opinion/op-eds/marco-rubio-we-need-to-invest-in-america-again.

[5] Marco Rubio, *American Investment in the 21st Century, Project for Strong Labor Markets and National Development*, (May 15 2019), available at https://www.rubio.senate.gov/public/_cache/files/94fcb79e-eedd-4496-a262-7091647563e6/B68DE3EF858700E482305C9ED26AEC72.5.14.2019.-final-project-report-american-investment.pdf.

made their case…"[6] and "the stock-market-driven short-termism story is weak."[7] Likewise, Steven Kaplan concludes that "there is very little long-term evidence that is consistent with the predictions of the short-term critics."[8] And, Larry Summers has noted that "[m]atters are not as clear as is often suggested regarding short-term driven 'quarterly capitalism,'" and "skepticism is appropriate towards arguments that horizons should be lengthened in all cases."[9]

We now consider empirical evidence regarding: (1) whether short-termism exists; (2) the causes of short-termism; and (3) the implications of short-termism, if any, for the broader economy.

a. Does short-termism exist?

While the empirical literature on whether, and to what extent, public companies prioritize short-term results at the expense of long-term growth is extensive, the results are inconclusive.[10] Empirical studies on the existence and extent of short-termism take several different approaches. One approach has been to survey public company executives, posing a direct question to management as to whether they would sacrifice long-term growth for short-term gains. Overall, the general consensus among these surveys is that corporate executives do report *feeling* short-term pressures.

Another approach focuses on the behavior of individual firms, specifically comparing public companies with private companies, under a presumption that any differences are attributable to short-term pressures felt by public, but not private, firms. Under this approach, the evidence is mixed, with different empirical studies reaching contrasting conclusions.

The final approach considers aggregate macro level data of U.S. public companies, focusing on metrics including shareholder distributions (e.g. dividends and stock buybacks) and investment spending. The evidence is also mixed under this approach.

Public company surveys

Although surveys of corporate executive and director views on short-termism are not plentiful, there have been two surveys that suggest that most corporate executives and directors feel pressure to satisfy the short-term expectations of public markets. The first survey, conducted by Graham, Harvey and Rajgopal (2005), found that 78% of corporate executives and directors would sacrifice long-

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6 Mark J. Roe, *Stock Market Short-Termism's Impact*, European Corporate Governance Institute (ECGI) - Law Working Paper No. 426/2018, 45 (October 22, 2018), available at https://ssrn.com/abstract=3171090.

7 Id at 46.

8 Steven N. Kaplan, *Are US Companies Too Short-Term Oriented? Some Thoughts*, 18 Innovation Policy and the Economy 107, 108 (2018).

9 Lawrence Summers, *Taking a Long View on Corporate Reform*, Washington Post (Aug. 9, 2015), available at https://www.washingtonpost.com/opinions/taking-a-long-view-on-corporate-reform/2015/08/09/c786cdb8-3d0c-11e5-9c2d-ed991d848c48_story.html.

10 See Scott Latham and Michael Braun, *Does Short-termism Influence Firm Innovation? An Examination of S&P 500 Firms, 1990-2003*, 22 Journal of Managerial Issues 368 (Fall 2010) ("In general, the debate on how managers reconcile short-term results and long-term competitive advantage remains equivocal."); Roe, *Stock Market Short-Termism's Impact* at 14 (cited in note 6) (noting that the empirical literature on short-termism is "extensive but disputed").

term investment to meet short-term earnings expectations.[11] A more recent McKinsey (2017) survey, updating previous surveys, found similar results, reporting that 87% of executives and directors felt pressure to deliver performance within 2 years or less, and that 65% said that short-term pressure had increased over the five-year period from 2011 to 2016.[12] A comparison of the 2017 McKinsey study with an earlier 2013 McKinsey study shows that short-term pressure on executives may have increased. In the 2017 study, the percentage of respondents reporting feeling pressure to deliver performance within 2 years or less was 7% higher than in the 2013 study.[13] Similarly, in the 2017 study, the percentage of respondents that were in favor of a planning horizon of 2 years or less was 10% higher than in the 2013 study.[14][13]

Firm-level comparisons: public versus private companies

The primary challenge for empirical examinations of short-termism is the identification of plausible counterfactuals. That is, to conclude that certain firm behavior is evidence of a short-term focus (e.g. decreased investment spending), it is necessary to identify how that firm would behave without short-term pressures.

An empirical study by Asker, Farre-Mensa and Ljungqvist (2015) attempts to address the counterfactual issue by comparing long-term investment by public companies with that of private companies, assuming that differences between long-term investment by public and private firms are attributable to short-term pressures in public markets.[15] This assumption is generally motivated by the fact that private firms are often owner-managed and even when not, they are illiquid and have highly concentrated ownership, which increases monitoring of management by private owners (versus public owners) to ensure that long-term value is maximized.[16] The study finds that public companies engage in substantially less long-term investment (capital expenditures and mergers and acquisitions) than private companies, and public companies are less responsive to new investment opportunities.[17] Ultimately, the study argues that its "findings highlight short-termist pressures as a potentially

[11] See John R. Graham, Campbell Harvey and Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. of Acc. and Econ. 3 (2005).

[12] See McKinsey Global Institute, *Measuring the Economic Impact of Short-Termism*, McKinsey & Company (February 2017), available at https://www.mckinsey.com/~/media/mckinsey/featured%20insights/Long%20term%20Capitalism/Where%20companies%20with%20a%20long%20term%20view%20outperform%20their%20peers/MGI-Measuring-the-economic-impact-of-short-termism.ashx.

[13] See Dominic Barton, Jonathan Bailey and Joshua Zoffer, *Rising to the challenge of short-termism*, FCLT Global 5 (Sept. 2016), available at https://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf.

[14] See id at 4.

[15] See John Asker, Joan Farre-Mensa and Alexander Ljungvist, *Corporate Investment and Stock Market Listing: A Puzzle?*, 28 Rev. of Fin. Stud. 342 (Feb. 2015).

[16] See id at 355, 373.

[17] See id at 355–56.

important cost of a stock market listing."[18]

Countering these results, Feldman et al. (2018) note that the Asker, Farre-Mensa and Ljungqvist study only considers capital expenditures and mergers and acquisitions (M&A) activity, while ignoring research and development (R&D) spending that also contributes to long-term growth.[19] When including R&D spending, the Feldman et al. study, finds that public firms invest more in R&D than their private counterparts, which they attribute to the ability of public stock markets to facilitate investment.[20] This result runs counter to the argument that public markets are prone to investment-chilling short-term behavior.

In another analysis that highlights the long-term patience of public firm investors for growth companies, Kaplan (2018) notes the prominent examples of public companies, such as Amazon, that have sustained high stock prices despite not earning any profits, all the while making substantial long-run investments that have subsequently paid off.[21] Moreover, in a 2019 editorial, Larry Summers and Anna Stansbury note that 84% of initial public offerings of technology companies are by companies that are not profitable.[22] Summers and Stansbury suggest that this trend illustrates that, at least when it comes to growth companies, "it does not seem that shareholder capitalism has created a systemic bias toward short-termism; on the contrary, shareholders have been willing to pay high prices for companies on the expectation that they will make profits in the distant future."[23]

Aggregate public company data

Other empirical research on short-termism focuses on *aggregate* levels of public company investment. In particular, in an empirical study frequently referenced by short-termism critics, Lazonick (2014) argues that the short-term incentives of corporate executives have led to an overall increase of profit distribution to shareholders, through dividends and stock buybacks, at the expense of long-term investment. Specifically, the study shows that from 2003–2012, S&P 500 companies paid out more than 90 percent of net income in the form of stock buybacks and dividends.[24] However, the statistics

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[18] See id at 384.

[19] See Naomi Feldman, Laura Kawano, Elena Patel, Nirupama Rao, Michael Stevens, and Jesse Edgerton, *The Long and the Short of It: Do Public and Private Firms Invest Differently*, Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series 2018-068 (August 2018), available at https://www.federalreserve.gov/econres/feds/files/2018068pap.pdf.

[20] See id at 19.

[21] See Kaplan, *Are US Companies Too Short-Term Oriented?* at 122 (cited in note 8).

[22] See Anna Stansbury and Lawrence H. Summers, *What Marco Rubio gets right – and wrong – about the decline of American investment*, Washington Post (May 31, 2019), available at https://www.washingtonpost.com/opinions/2019/05/31/what-marco-rubio-gets-right-wrong-about-decline-american-investment/.

[23] Id. See also Roe, *Stock Market Short-Termism's Impact* at 29 (cited in note 6) ("[T]he American companies *most strongly supported* by the stock market – are Amazon, Apple, Alphabet (Google), Facebook, and Microsoft. All are quintessential long-term companies… Their current earnings cannot justify their current stock price; only a belief that they will grow long-term does.").

[24] See William Lazonick, *Profits without Prosperity*, Harvard Business Review (Sep. 2014).

cited by Lazonick are not without dispute. Fried and Wang (2018) illustrate several flaws in Lazonick's analysis, noting that public firms also raise capital through equity issuances, partially offsetting the capital drain that results from shareholder distributions.[25] When considering *net distributions* (i.e. including capital raised over the same time period), S&P 500 companies only paid out 50% of net income in the form of dividends and share buybacks.[26] A more complete discussion of the stock buyback debate can be found in the third section of this report.

Echoing Lazonick's concerns, Coffee and Palia (2016) argue that short-termism is evidenced by the fact that a smaller percentage of public companies' cash flows are being directed towards capital expenditures.[27] In addition, Garel (2017) finds reductions in R&D investment.[28] However, other empirical studies suggest that the decline in capital expenditures may not be the result of short-term pressures. Roe (2018) notes that much of the decline in capital expenditures occurred during the global financial crisis, as the result of a global recession and not due to otherwise increasing short-term pressures.[29] In fact, as illustrated in **Figure 1**, capital expenditures as a percentage of GDP have increased since 2009.[30] Additionally, Roe finds that capital expenditures have declined globally, with the rate of U.S.-decline being only half of other OECD countries (including non-stock market sectors),[31] suggesting that other global macroeconomic factors may have caused a decrease in capital expenditures, rather than short-termism in U.S. public markets.[32]

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[25] See Jesse M. Fried and Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment?*, Harvard Business Review (March-Apr. 2018).

[26] See Committee on Capital Markets Regulation, *Nothing But The Facts: Restricting Stock Buybacks Would Harm U.S. Capital Markets* (Feb. 19, 2019), available at https://www.capmktsreg.org/wp-content/uploads/2019/02/02-19-CCMR- NBTF-Proposals-to-Restrict-Stock-Buybacks.pdf.

[27] See John C. Coffee and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 Annals of Corp. Gov. 1 (2016).

[28] See Alexandre Garel, *Myopic Market Pricing and Managerial Myopia*, 44 J. of Bus. Fin. & Acc. 44 (Oct./Nov. 2017).

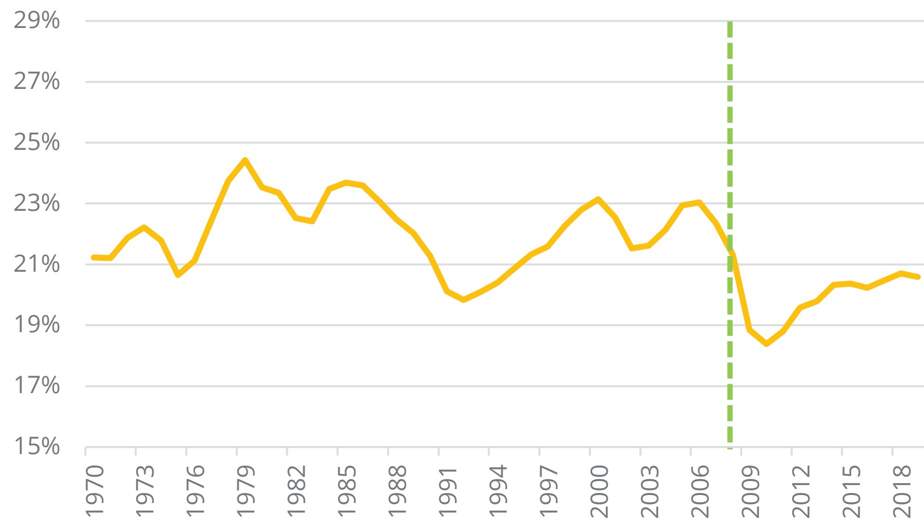
[29] See Roe, *Stock Market Short-Termism's Impact* at 18–19 (cited in note 6).

[30] See id at 17.

[31] See id at 20.

[32] See also Salman Arif and Charles M.C. Lee, *Aggregate Investment and Investor Sentiment*, 27 Rev. of Fin. Stud. 3241 (November 2014) (finding that corporate investments peak during periods of positive sentiment and that higher aggregate investment precede lower earnings and macroeconomic growth).

Figure 1. Capital Expenditures in the United States, 1970-2016, Scaled to GDP.[33]



b. Potential causes of short-termism

Proponents of the short-termism thesis have identified several factors that potentially cause the short-term focus of public companies. One potential factor is that certain public company shareholders have relatively short-term holding periods and therefore may be more focused on the short-term appreciation of a stock's price rather than its long-term prospects.[34] A second potential contributing factor is that short-term increases in stock prices typically result in increases in executive compensation for management.[35] And a third possible cause of short-termism is the requirement for public companies to disclose quarterly financial performance and the corresponding earnings release guidance issued by certain companies. Presumably, management feels pressure to show improvements in operating performance at these quarterly intervals.[36] A fourth potential cause of short-termism is the threat of shareholder activism.[37]

i. Short-term holding periods

The average holdings period of shares in U.S. public companies has declined in recent decades, from

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[33] See Organization for Economic Co-operation and Development, Gross Fixed Capital Formation in United States, available at https://fred.stlouisfed.org/series/USAGFCFADSMEI; U.S. Bureau of Economic Analysis, Gross Domestic Product, available at https://fred.stlouisfed.org/series/GDPA.

[34] See Roe, *Stock Market Short-Termism's Impact* at 19–20 (cited in note 6).

[35] See id.

[36] See, for example, Larry Summers and Ed Balls, *Report of the Commission on Inclusive Prosperity*, Center for American Progress 35 (January 2015) (noting that "[o]ne reason that economists have advanced for [the] transition to corporate short-termism is the overwhelming shift to stock-market-based compensation for CEOs and other highly compensated executives at publicly traded corporations.").

[37] See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports*, 83 Fed. Reg. 65601 (Dec. 18, 2018).

roughly 2 years in 1990 to less than 1 year in 2017.[38] However, whether these statistics actually indicate a growing short-term focus among investors is dubious. Average holding periods are estimated based on share turnover: how much of a company's outstanding stock is traded over a given period. Much of the recent increase in turnover is therefore driven by the rise of high-frequency trading, not changes in behavior by investors. In other words, trading volumes have largely increased due to an increase in the frequency with which liquidity providers such as market makers buy and sell stock. It would therefore be inaccurate to contend that the decrease in the average holding period of U.S. stocks is due to changes in the investment horizon for investors. The stability of holding periods for large institutional investors further suggests that reduced average holding periods do not reflect widespread changes in the investment horizon of investors.[39] Recent academic studies confirm this interpretation.[40]

The portion of investors in public companies that are short-term versus long-term is unclear. In one recent study, Harford, Kecskes and Mansi (2017) suggest that, as of 2012, approximately 24% of U.S. public equity was held by long-term institutional investors, with another 36% held by short-term institutional investors and 40% held by non-institutional investors whose investment horizons are unclear.[41] The authors conclude that "[institutional] [i]nvestors as a group have not become more short-term over time; instead, short-term investors have increased the frequency of their trading."[42]

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[38] See Roe, *Stock Market Short-Termism's Impact* at 11–12 (cited in note 6). See also World Federation of Exchanges, Stocks traded, turnover ratio of domestic shares (%) - United States, available at https://data.worldbank.org/indicator/CM.MKT.TRNR?end=2018&locations=US&start=1984&view=chart (turnover ratio of U.S. shares increased from 66% in 1990 to 116% in 2017).

[39] See Mark J. Roe, *Corporate Short-Termism – In the Boardroom and in the Courtroom*, 68 The Business Lawyer 977, 999 (Aug. 2013).

[40] See Paul H. Edelman, Wei Jiang and Randall S. Thomas, *Will Tenure Give Corporate Managers Lifetime Tenure?*, Vanderbilt Law Research Paper No. 18-04; European Corporate Governance Institute (ECGI) - Law Working Paper No. 384/2018 34 (Feb. 1, 2018) (noting that "[t]he annual turnover rates at the stock level started to trend up in the 1980s and then increased dramatically around mid-2000s, coincided with rise of algorithmic trading. However, it is important to note… that increasing turnover rates at the stock level do not imply that the typical or most institutional investors are churning their portfolio faster, nor does it suggest that companies are increasingly held by short-term investors."); Charles Nathan and Kal Goldberg, *The Short-Termism Thesis: Dogma vs. Reality*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 18, 2019), available at https://corpgov.law.harvard.edu/2019/03/18/the-short-termism-thesis-dogma-vs-reality/ (noting that "[s]tockholding duration is commonly measured by aggregating all trades in a given security during a period and dividing by the number of shares outstanding. Thus, trades by program traders count as much as trades by long-term investors. When holdings of long-term investors are viewed separately, the findings are that duration of ownership has remained constant, and in some instances increased, over the past 30 years."). See also Roe, *Stock Market Short-Termism's Impact* at 33 (cited in note 6).

[41] See Jarrad Harford, Ambrus Kecskes, and Sattar Mansi, *Do Long-Term Investors Improve Corporate Decision Making?*, 50 J. of Corp. Fin. 424, 429–30 (2018) (defining "long-term investors" as those with less than 35% three-year portfolio turnover).

[42] Id at 429.

ii. *Stock-based compensation*

Theory predicts that management should be more prone to short-termism when executive compensation is linked to short-term stock price movements. Empirical studies provide support for this theory. Ladika and Sautner (2020) examine the relationship between executive compensation and long-term investment, finding that when executives are allowed to exercise their stock options sooner than originally scheduled, then long-term investments are reduced and short-term earnings increase, making the vested options more valuable as stock prices rise in the short-term.[43] They also find that companies that reduce the vesting period of their executive's stock options underperform the market in the long run.[44]

Edmans, Fang and Lewellen (2017) find that companies with a significant amount of equity compensation vesting in a given quarter tend to spend less on investments.[45] A follow-up study by Edmans, Fang and Huang (2018) finds that increased short-term incentives for CEOs (again measured by the amount of equity vesting in a given quarter) is associated with increased probabilities of share buybacks and M&A activity.[46] While stocks returns for these companies are positive in the quarters immediately following share buybacks and M&A activity, stock returns turn negative two years after buybacks and four years after M&A activity.[47]

iii. *Quarterly reporting and earnings guidance*

Recently, there has been a public debate about whether mandatory quarterly financial reporting and voluntary quarterly earnings guidance increase pressure on public companies to perform in the short-term. Corporate attorney Martin Lipton has urged the SEC to give public companies the option of discontinuing quarterly reporting.[48] JPMorgan Chase Chairman and CEO Jamie Dimon and Berkshire Hathaway CEO Warren Buffet have argued that "quarterly earnings guidance often leads to an unhealthy focus on short-term profits at the expense of long-term strategy, growth and sustainability."[49]

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[43] See Tomislav Ladika and Zacharias Sautner, *Managerial Short-Termism and Investment: Evidence from Accelerated Option Vesting*, 24 Rev. of Fin. 305, 322–27 (March 2020).
[44] See id.
[45] See Alex Edmans, Vivian W. Fang and Katharina A. Lewellen, *Equity Vesting and Investment*, 30 Rev. of Fin. Stud. 2229 (July 2017).
[46] See Alex Edmans, Vivian W. Fang and Allen Huang, *The Long-Term Consequences of Short-Term Incentives*, European Corporate Governance Institute (ECGI) - Finance Working Paper No. 527/2017 (Mar. 13, 2020), available at https://ssrn.com/abstract=3037354.
[47] See id at 13–23.
[48] See Martin Lipton, *Legal & General Calls for End to Quarterly Reporting,* Harvard Law School Forum on Corporate Governance and Financial Regulation (Aug. 19, 2015), available at https://corpgov.law.harvard.edu/2015/08/19/legal-general-calls-for-end-to-quarterly-reporting/.
[49] See Jamie Dimon and Warren E. Buffet, *Short-Termism Is Harming the Economy*, Wall Street Journal (June 6, 2018), available at https://www.wsj.com/articles/short-termism-is-harming-the-economy-1528336801.

Quarterly reporting

In August 2018, President Trump requested via Twitter that the SEC consider moving from a quarterly reporting system to a six-month financial reporting system.[50] In response, the SEC committed to studying public company financial reporting.[51] In December 2018, the SEC issued a request for comment on quarterly earnings releases and quarterly reports, considering whether the current system "foster[s] an inefficient outlook among registrants and market participants by focusing on short-term results."[52] The SEC received over 80 comment letters, including comments from large public companies, national stock exchanges, major accounting and law firms, buy-side entities and other financial institutions.[53]

The majority of commenters did not support replacing the quarterly system, but instead recommended streamlining and simplifying the reporting process and discouraging quarterly earnings guidance. For example, FedEx Corporation encouraged the SEC to "streamline required disclosures and eliminate duplicative information in quarterly reporting."[54] BlackRock noted quarterly reporting may increase management's focus on short-term results, but they "believe the loss in transparency and timely availability of information would outweigh potential benefits" and pointed to quarterly earnings guidance as a driver of short-termism.[55] Both Bank of America and State Street Corporation agreed that the quarterly reporting framework should stay in place, with modifications to the content

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[50] In a tweet President Trump stated: "In speaking with some of the world's top business leaders I asked what is it that would make business (jobs) even better in the U.S. 'Stop quarterly reporting & go to a six month system,' said one. That would allow greater flexibility & save money. I have asked the SEC to study!" See Dave Michaels, Michael Rapoport and Jennifer Maloney, *Trump Asks SEC to Study Six-Month Reporting for Public Companies*, Wall Street Journal (Aug. 17, 2018), available at https://www.wsj.com/articles/trump-directs-sec-to-study-six-month-reporting-for-public-companies-1534507058.

[51] See Jay Clayton, *Statement on Investing in America for the Long Term* (Aug. 17, 2018), available at https://www.sec.gov/news/public-statement/statement-clayton-081718.

[52] See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports*, 83 Fed. Reg. 65,601 (Dec. 21, 2018), available at https://www.govinfo.gov/content/pkg/FR-2018-12-21/pdf/2018-27663.pdf. The SEC also held a roundtable in July 2019 that focused on the impact of short-termism on U.S. capital markets. Reactions from panelists were mixed on whether quarterly reporting contributed to short-termism and some called on the SEC to instead focus on reforming or banning quarterly earnings guidance. See Securities and Exchange Commission, *Roundtable on Short-Term / Long-Term Management of Public Companies* (Jul. 18, 2019), available at https://www.sec.gov/video/webcast-archive-player.shtml?document_id=roundtable-short-long-term-071819.

[53] See Securities and Exchange Commission, *Comments on Earnings Releases and Quarterly Reports*, https://www.sec.gov/comments/s7-26-18/s72618.htm (last visited Oct. 29, 2019).

[54] See John L. Merino and Jennifer L. Johnson, *FedEx Corporation Letter in Response to the Securities and Exchange Commission's Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5167619-183471.pdf.

[55] See Barbara Novick and Thomas Clark, *BlackRock, Inc. Letter in Response to the Securities and Exchange Commission's Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5165791-183444.pdf.

of disclosures.[56]

History of quarterly reporting in the United States

In 1926 the New York Stock Exchange asked NYSE-listed firms to commit to quarterly reporting.[57] With the passage of the Securities Exchange Act of 1934 ("Exchange Act"), the SEC began requiring annual reporting of financial statements by all public companies.[58] The SEC itself did not require quarterly reporting until 1945, when the SEC required firms with war contracts exceeding 25% of sales to file quarterly reports due to concerns that investors would be unprepared for a reduction in sales following World War II.[59] In 1946, the SEC went further and required most exchange-listed companies to report revenues quarterly.[60]

The SEC quarterly revenues reporting rules were rescinded in 1953,[61] and the SEC shifted to semi-annual reporting requirements in 1955.[62] The SEC again began mandating quarterly financial reports on Form 10-Q in 1970,[63] as part of a program to improve disclosures made under the Exchange Act prompted by a report from the legal and accounting profession, securities industry and business community to the SEC entitled "Disclosure to Investors–A Reappraisal of Administrative Policies under the '33 and '34 Acts".[64] This report issued at the direction of SEC Commissioner Francis Wheat was meant to find ways to, among other items, "clarify the law of disclosure and make its application more certain" and "enhance the utility to investors and to those who advise them of the documents generated under the Federal securities statutes."[65] The SEC "propos[ed] to adopt regular quarterly reporting which [would] provide detailed information as a back-up to" Form 8-K's event-driven disclosure requirements, which the SEC was concerned were not widely used at the time by investors

[56] See John M. James, *Bank of America Letter in Response to the Securities and Exchange Commission's Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5169917-183472.pdf; Ian Appleyard, *State Street Corporation Letter in Response to the Securities and Exchange Commission's Request for Comment on Earnings Releases and Quarterly Reports* (Mar. 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5162557-183436.pdf .

[57] For a history of financial reporting in the U.S., see Marty Butler, Arthur Kraft and Ira S. Weiss, *The effect of reporting frequency on the timeliness of earnings: The cases of voluntary and mandatory interim reports*, 43 J. of Acc. and Econ. 181, 184–86 (2007); Arthur Kraft., Rahul Vashishtha and Mohan Venkatachalam, *Frequent Financial Reporting and Managerial Myopia*, 93 Acc. Rev. 249 (2018).

[58] See Butler et al., *The effect of reporting frequency on the timeliness of earnings* at 185 (cited in note 57).

[59] See id at 186.

[60] See id.

[61] See Securities and Exchange Commission, *Twentieth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1954* (Nov. 1954), available at https://www.sec.gov/about/annual_report/1954.pdf.

[62] See Butler et al., *The effect of reporting frequency on the timeliness of earnings* at 186 (cited in note 57).

[63] See id.

[64] See Securities and Exchange Commission, *Disclosure to Investors–A Reappraisal of Administrative Policies under the '33 and '34 Acts*, Staff Report directed by Francis M. Wheat, announced in Securities Act Release, No. 4963 (April 1969).

[65] Id.

or their advisors to receive information pertinent to their investments.[66] Quarterly reporting has been mandatory in the United States since the 1970s.

In the period between 1950 to 1970, as public firms in the United States began to increase the frequency of financial reporting, Kraft, Vashishtha and Venkatachalam (2018) found that there was a decline in investment after a firm increased their reporting frequency and that firms that reported more frequently were more likely to have a subsequent decline in operating efficiency and sales growth.[67] They concluded these findings were due to increased capital market pressures to achieve short term performance objectives.[68] On the other hand, Fu, Kraft and Zhang (2012) found that increased reporting frequency reduced the cost of capital in the period from 1951 through 1973 due to a reduction in information asymmetry between investors and executives at the company.[69]

A European case study

The European Union has also undergone recent changes regarding the mandatory frequency of financial reporting by public companies. In 2007, the EU began requiring firms to publish quarterly "interim management statements" describing each company's financial position and performance over the relevant period.[70] This effectively moved the EU onto a mandatory quarterly reporting regime from a semi-annual regime. However, the EU moved to eliminate their new quarterly reporting obligations in 2014, asserting that quarterly reporting "encourage[s] short-term performance and discourage[s] long-term investment."[71] By November 2015, member states, including the U.K., had returned to mandatory semi-annual reporting regimes.[72]

Regardless, many public companies in the EU continued to voluntarily report on a quarterly basis immediately after the EU rescinded its quarterly reporting requirement. For example, in 2015, 90%

[66] See Securities and Exchange Commission, *Form 10-Q for Disclosure of Financial Information, Notice of Proposed Rule Making*, 34 Fed. Reg. 14239 (Sept. 10, 1969).

[67] See Kraft et al., *Frequent Financial Reporting and Managerial Myopia* (cited in note 57).

[68] See id at 274–75.

[69] See Renhui Fu, Arthur Kraft and Huai Zhang, *Financial Reporting Frequency, Information Asymmetry and the Cost of Equity*, 54 J. of Acc. and Econ. 139 (2012).

[70] See *Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC*, OJ L 390/38 (Dec. 15, 2004).

[71] *Directive 2013/50/EU of the European Parliament and of the Council amending Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, Directive 2003/71/EC of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Directive 2007/14/EC laying down detailed rules for the implementation of certain provisions of Directive 2004/109/EC*, OJ L 294/13 (Oct. 22, 2013).

[72] See U.K. Financial Conduct Authority, *Policy Statement PS14/15: Removing the Transparency Directive's requirement to publish interim management statements* (Nov. 2014), available at https://www.fca.org.uk/publication/policy/ps14-15.pdf (implementing the directive ahead of schedule).

of U.K. public companies voluntarily published quarterly reports.[73] Initially, the U.K. companies abandoning quarterly reporting were mostly small domestic companies.[74] However, a much broader trend away from voluntary quarterly reporting is now evident in the U.K. Between October 2016 and August 2017, (i) the number of FTSE 100 companies voluntarily issuing quarterly reports fell from 70 to 57, and (ii) the number of FTSE 250 companies doing so fell from 111 to 83.[75] Nevertheless, the trend away from quarterly reporting has varied by jurisdiction. For example, companies listed on the Deutsche Börse under the "prime standard", a segment of the exchange with the highest transparency standards that exceed the "general standard" required by law, must publish quarterly reports.[76] As of October 2019, 308 of the 502 companies listed on the Deutsche Börse were voluntarily listed on the prime standard,[77] meaning that over 60% of companies on the Deutsche Börse still publish quarterly reports.

In examining the shift to and from mandatory quarterly reporting, researchers have reached differing conclusions as to the impact of quarterly reporting on short-termism. Ernstberger, Link, Stich, and Vogler (2015) examine how mandatory quarterly reporting affected R&D.[78] To do so, they analyzed EU firms that switched to mandatory quarterly reporting in 2007.[79] They found that the shift to mandatory quarterly reporting was correlated with increased cuts to R&D to boost short-term performance metrics, and that these cuts weighed on operating performance after the first year.[80] Conversely, Pozen, Nallareddy and Rajgopal (2017) analyzed the effect of quarterly reporting on capital investment at U.K. companies between 2005 and 2015.[81] They found that when companies were required to report quarterly in 2007, rather than semiannually, the level of investment was generally unchanged.[82] They also found that the change back from quarterly to semiannual reporting did not

[73] See Robert Pozen, Suresh Nallareddy, and Shivaram Rajgopal, *Impact of Reporting Frequency on UK Public Companies*, CFA Institute Research Foundation Briefs 12 (March 2017), available at https://www.cfainstitute.org/-/media/documents/article/rf-brief/rfbr-v3-n1-1-pdf.ashx.

[74] See id.

[75] See Owen Walker, *The long and short of the quarterly reports controversy*, Financial Times (July 1, 2018), available at https://www.ft.com/content/e61046bc-7a2e-11e8-8e67-1e1a0846c475.

[76] See Deutsche Börse Group, *Prime Standard* (last accessed Oct. 21, 2019), available at https://www.deutsche-boerse.com/dbg-en/our-company/know-how/glossary/glossary-article/Prime-Standard-243278. See also Philipp Melzer, *New financial reporting requirements for listed companies in 2016*, Lexology (July 4, 2016), available at https://www.lexology.com/library/detail.aspx?g=b72104cc-7dc2-42be-845a-4b75fbe0c3bd.

[77] See Deutsche Börse Group, *Listed Companies* (last accessed Oct. 21, 2019), available at https://www.deutsche-boerse-cash-market.com/dbcm-en/instruments-statistics/statistics/listes-companies.

[78] See Jurgen Ernstberger, Benedikt Link, Michael Stich, and Oliver Vogler, *The Real Effects of Mandatory Quarterly Reporting*, 92 Acc. Rev. 33 (2017).

[79] See id at 34.

[80] See id at 56.

[81] See Pozen et al., *Impact of Reporting Frequency on UK Public Companies* at 5 (cited in note 73).

[82] See id at 6–7.

create any significant benefit, or harm, to firms that discontinued quarterly reporting.[83]

Overall, empirical studies are mixed as to the impact on investment by public companies from regulatory changes regarding the frequency of mandatory reporting, with some finding investment decreased after mandatory quarterly reporting was implemented and others finding that there was not a significant effect on investment.

Quarterly earnings guidance

Short-termism critics have also argued that the *voluntary* issuance of forward-looking quarterly earnings guidance[84] can encourage companies to manage around quarterly targets at the expense of long-term investment, and attract investors with "a short-term orientation who intensify the attention to short-term results and eschew strategies with long-term payoffs."[85]

Issuance of quarterly earnings guidance increased after the turn of the millennium, increasing from less than 10% of U.S. public companies in the mid-1990s to a peak of nearly 50% of large cap companies in 2004.[86] Many market participants assume that quarterly earnings guidance continues to be a widespread practice, but U.S. public companies have been shifting away from quarterly earnings guidance.[87] As of 2016, only 28% of the S&P 500 issued quarterly earnings guidance, down from 36% in 2010.[88]

Certain studies have found links between quarterly earnings guidance and short-termism concerns. Cheng, Subramanyam and Zhang (2005) found that firms that issue quarterly earnings guidance invested less in R&D and had lower long-term growth rates compared to companies that did not issue guidance.[89] A survey by FCLT Global found that earnings guidance policy from 2010 through 2016 had no effect on price-to-earnings ratios and that companies that offer annual range guidance had lower volatility around earnings reporting periods compared to those that issued quarterly

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[83] See Suresh Nallareddy, Robert Pozen and Shivaram Rajgopal, *Consequences of Mandatory Quarterly Reporting: The U.K. Experience*, Columbia Business School Research Paper No. 17-33 (Mar. 15, 2017), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2817120. Similarly, a study of firms in Singapore found no evidence of myopic investment by firms that are required to publish quarterly financial statements compared to those that are not required to publish quarterly financial statements. See Peter Kajüter, Florian Klaussmann and Martin Nienhaus, *The Effect of Mandatory Quarterly Reporting on Firm Value*, 94 Acc. Rev. 251 (2019).

[84] See Securities and Exchange Commission, *Request for Comment on Earnings Releases and Quarterly Reports* at 65604 (cited in note 52).

[85] FCLT Global, *Comment Letter Regarding Earnings Releases and Quarterly Reports* (March 21, 2019), available at https://www.sec.gov/comments/s7-26-18/s72618-5167609-183488.pdf. See also Ariel Fromer Babcock and Sarah Keohane Williamson, *Moving Beyond Quarterly Guidance: A Relic of the Past*, FCLT Global 5 (Oct. 2017) ("Companies that choose to offer shareholders a long-term vision and strategy benefit not only from a reduced focus on short-term metrics but also by attracting and building a long-term investor base.").

[86] See id at 8.

[87] See id at 8–11.

[88] See id at 6.

[89] See Mei Cheng, K. R. Subrahmanyam, and Yuan Zhang, *Earnings Guidance and Managerial Myopia* (Nov. 2005), available at https://ssrn.com/abstract=851545.

guidance,[90] suggesting that companies would not be harmed by discontinuing the practice of issuing quarterly earnings guidance.[91]

If quarterly earnings guidance were to exacerbate short-termism concerns, then decisions to cease such guidance should result in benefits for long-term investors. However, the empirical evidence relating to this proposition is mixed. Finding positive benefits, Kim, Su and Zhu (2017) report that companies that stopped issuing quarterly earnings guidance attracted a greater number of long-term investors, placed more weight on long-term earnings and had a lower sensitivity to short-term analyst forecasts compared to firms that issued quarterly earnings guidance.[92] Other studies, however, have found contrasting results. Houston, Lev and Tucker (2010) find that firms that cease quarterly earnings guidance do not subsequently increase capital investments or research and development expenditures.[93] They report that firms stop quarterly guidance primarily because of poor performance—not because they are focused on the long-term. In addition, they find that nearly one-third of firms that ceased quarterly guidance—particularly firms that experience fewer loss quarters and better earnings performance after they stop providing guidance—chose to resume guidance after six quarters.[94]

Empirical studies also confirm benefits that accrue to firms through the issuance of earnings guidance. By disclosing and meeting earnings forecasts, management provides investors with valuable information that lowers uncertainty and, as a result, lowers a firm's cost of equity capital. In studying this effect, Chen, Matsumoto and Rajgopal (2011) find evidence that ceasing quarterly earnings guidance can lead to an increase in a firm's cost of capital, driven by the theory that investors typically reward firms that provide guidance with lower equity capital costs.[95] This result is consistent with other empirical studies finding more generally that earnings guidance reduces a firm's cost of capital. For example, Baginski and Rakow (2012) find that firms with more frequent earnings forecasts tend to have lower costs of equity capital.[96] Additionally, in looking at firms globally (i.e. U.S. and non-U.S.), Cao et al. (2017) determine that equity capital costs are 30 to 60 basis points lower for firms

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[90] See Babcock and Williamson, *Moving Beyond Quarterly Guidance* at 11–12 (cited in note 85).

[91] When comparing volatility and price-to-book ratios for U.S. firms that decreased the frequency of their earnings-per-share guidance, no effect on volatility or P/B ratios were found from the guidance change. See id at 12.

[92] See Yongtae Kim, Lixin (Nancy) Su and Xindong (Kevin) Zhu, *Does the Cessation of Quarterly Earnings Guidance Reduce Investors' Short-Termism?*, 22 Rev. of Acc. Stud. 715 (2017).

[93] See Joel F. Houston, Baruch Lev and Jennifer Wu Tucker, *To Guide or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance*, 27 Cont. Acc. Research 143 (2010).

[94] See id.

[95] See Shuping Chen, Dawn Matsumoto and Shivaram Rajgopal, *Is Silence Golden? An Empirical Analysis of Firms that Stop Giving Quarterly Earnings Guidance*, 51 J. of Acc. and Econ. 134 (2011). However, the findings of Chen et al. only find a relatively weak link between quarterly earnings guidance and cost of capital, arguably due to the relatively high variance in cost of capital measures across firms.

[96] See Stephen P. Baginski and Kenneth C. Rakow Jr., *Management earnings forecast disclosure policy and the cost of equity capital*, 17 Rev. of Acc. Stud. 279 (2012).

issuing earnings guidance.[97]

The issue of the impact of earnings guidance on long-term investment and growth can also be evaluated by the types of firms that issue such guidance. Boone et al. (2019) show that mature firms with fewer growth options, and thus less uncertainty about future prospects, are more likely to provide earnings guidance.[98] Conversely, firms that spend heavily on research and development (e.g. biotechnology firms) are less likely to provide earnings guidance.[99] Larger firms and those with higher levels of institutional ownership and analyst coverage are also more likely to provide earnings guidance.[100] In fact, as Chen et al. found, the firms that choose to cease providing quarterly guidance are those with low institutional ownership and low analyst coverage.[101] These results suggest that firms do not abandon quarterly guidance in an effort to relieve short-term pressures, but rather do so simply when demand for such guidance is relatively low.[102]

iv. Shareholder activism

Shareholder activism has increased over the past two decades. BlackRock's Larry Fink has noted that "[t]he role of activists is getting larger."[103] **Figure 2** below, adapted from Roe (2018), illustrates the rise in shareholder activism. Roe (2018) also notes that nearly 10 percent of all U.S. public companies can expect to face activist campaigns in a given year.[104] We address the impact of activism on firm value and long-term investment in the next section of this report.

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[97] See Ying Cao, Linda A. Myers, Albert Tsang and Yong George Yang, *Management forecasts and the cost of equity capital: international evidence*, 22 Rev. of Acc. Stud. 791 (2017).

[98] See Audra Boone, Craig Lewis, Austin Starkweather, and Joshua T. White, *Is the bottom line the top priority? Revenue versus earnings guidance* (Oct. 27, 2019), available at http://faculty.bus.olemiss.edu/rvanness/Speakers/Presentations%202019-2020/Disaggregated_Guidancepdf.pdf.

[99] See id at 14–15. However, these firms are more likely to provide *revenue* guidance. See id.

[100] See id.

[101] See Chen et al.,*Is Silence Golden?* at 140–42.

[102] See id at 140. (" Because analysts are the primary beneficiaries of earnings guidance, firms with increases in analyst following also likely feel greater pressure to continue providing guidance.") However, Chen et al. suggest that firms may cease providing guidance—stopping a practice associated with a short-term focus—in an attempt to attract more long-term institutional investors. See id.

[103] Svea Herbst-Bayliss and Ross Kerber, *BlackRock's Fink Learns to Live with Activist Investors*, Reuters (Nov. 13, 2017), available at https://www.reuters.com/article/us-investment-summit-fink-shareholders/blackrocks-fink-learns-to-live-with-activist-investors-idUSKBN1DD2B6.

[104] Roe, *Stock Market Short-Termism's Impact* at 12 (cited in note 6).

Figure 2. Rising Incidence of High-Impact Shareholder Activism, 1994-2016.

c. Effects of short-termism

If public companies tend to forgo long-term investments for short-term gains, then the consequences of short-termism should be reflected in the broader economy. But, similar to the empirical literature on the existence of short-termism, the literature on the effects of short-termism on the broader economy is inconclusive.

One way that short-termism could lead to negative economic effects is by reducing the growth of companies that are focused on the short term, therefore resulting in lower job creation and profits for shareholders that can be reinvested in the economy. A study conducted by McKinsey, for example, found that between the years 2001 and 2014, the revenue of companies that were focused on the long term (calculated based on a five-factor Corporate Horizon Index[105]) cumulatively grew on average 47% more than the revenue of other companies. In addition, the earnings of those long-term focused companies grew 36% more than other companies. They also added more jobs (12,000 on

[105] The five factors in the Corporate Horizon Index are (i) investment (measuring ratio of capital expenditures to depreciation), (ii) earnings quality (measuring accruals as a share of revenue), (iii) margin growth (measuring the difference between earnings growth and revenue growth), (iv) quarterly management (measuring incidence of beating EPS targets by less than two cents and incidence of missing EPS targets by less than two cents), and (v) earnings-per-share growth (measuring difference between EPS growth and true earnings growth). The hypothesis behind these factors is that long-term firms will invest more, generate earnings that are reflected in cash flow, are less likely to over-index on EPS and are more willing to miss short-term targets if needed, and short-term firms are more likely to grow margins unsustainably in order to hit near-term targets and will do whatever they can to hit short-term targets. See McKinsey Global Institute, *Measuring the Economic Impact of Short-Termism* at 3 (cited in note 12).

average from 2001-2015) and invested more in R&D (50% more on average) than other companies.[106] McKinsey also found that long-term firms delivered greater total returns to shareholders than other companies.[107] Similarly, Brochet, Loumioti and Serafeim (2015) found a correlation between companies that they identified as short-term oriented and lower return on equity and lower future profitability.[108]

On the other hand, a certain amount of short-termism may be beneficial for the long-term value of companies.[109] Thakor (2016) argues that short-termism can benefit firms by preventing investments in bad projects and enabling faster learning about managerial ability.[110] Similarly, Kaplan (2018) argues that "some of the…short-term pressures can actually prompt companies to become more efficient."[111] Barzuza and Talley (2019) argue that corporate managers can be overly optimistic on the likelihood of the success of projects, costing investors in the long term, and that short-termism can be an appropriate check for management.[112]

The short-termism debate has persisted for decades: critics have been warning about the excessive short-term focus of U.S. companies since at least the late 1970s and early 1980s. Accordingly, the recent history of corporate performance can shed light on whether their predictions about the long-term consequences of managerial myopia have materialized. Kaplan notes that if those early critics of short-termism had been correct, then the long-run consequences of underinvestment would be playing out today, forty years later.[113] But corporate profits are now at near-record highs, which suggests that the concerns voiced by earlier critics of short-termism—that excessive focus on short-term results deterred companies from investing in profitable, long-term projects—were overblown.[114]

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[106] See id at 4–7.

[107] See id at 6.

[108] See Francois Brochet, Maria Loumioti and George Serafeim, *Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia*, 20 Rev. of Acc. Stud. 1122 (2015).

[109] See David Marginson and Laurie McAulay, *Exploring the Debate on Short-Termism: A Theoretical and Empirical Analysis*, 29 Strat. Mgmt. J. 273, 274 (March 2008) ("Balancing the needs of both the long term and the short term is thus important and gives rise to two possibilities. The first is that managers' short-term actions extrapolate into optimal long-term consequences.").

[110] See Richard Thakor, *A Theory of Efficient Short-termism* (Aug. 2016), available at https://ssrn.com/abstract=2821162.

[111] Kaplan, *Are US Companies Too Short-Term Oriented?* at 121 (cited in note 8); see also Stansbury and Summers, *What Marco Rubio gets right – and wrong – about the decline of American investment* (cited in note 22) ("[W]e are not altogether sure that a more long-term, institution building approach, without shareholder pressure, always results in more efficient allocation of investment.").

[112] See Michal Barzuza and Eric Talley, *Long-Term Bias*, Virginia Law and Economics Research Paper No. 2019-05; European Corporate Governance Institute (ECGI) - Law Working Paper No. 449/2019 (May 2019), available at https://ssrn.com/abstract=3338631.

[113] See Kaplan, *Are US Companies Too Short-Term Oriented?* at 109–11 (cited in note 8).

[114] See id.

2. Shareholder activism

Shareholder activism refers to tactics employed by shareholders of a company that are aimed at increasing, in the short term (often one year), the value of their stake in the company.[115] The tactics used by activist shareholders range from shareholder proposals seeking corporate policy changes or disclosures related to a particular issue, to proxy fights aimed at replacing boards of directors, in whole or in part.[116] As former Chief Justice of the Delaware Supreme Court Leo Strine has noted, "whether the corporations that activists leave behind are better or worse positioned to generate sustainable profits in the future is debatable."[117]

This section begins by surveying the prevalence of shareholder activism in the U.S., including its recent increase. It then provides an overview of empirical studies that attempt to measure the short-term and long-term effects of activism. Much of the current debate surrounding the value of activism, and its relationship to short-termism in particular, focuses on the aggressive tactics used by certain activist hedge funds.[118] Accordingly, this section will focus primarily on the empirical literature related to hedge fund activism. Overall, the majority of studies find that hedge fund activism confers positive short-term benefits on public companies, while the evidence of long-term benefits is mixed.[119] This section concludes by discussing the link between the rise of shareholder activism and the rise of passive investing.

a. Prevalence of activism

Lazard's annual review of shareholder activism reports that 2018 was a record-breaking year for shareholder activism; 2019 saw a decrease in activist campaigns, but the number of campaigns remained in line with multi-year average levels. **Figure 3** shows annual activist campaign activity since 2013. In 2019, 187 companies were targeted in 209 campaigns, down from the record 226 companies that were targets of 247 activist campaigns in 2018, but consistent with the 188 companies targeted by 212 campaigns in 2017. These numbers were significantly higher than just five years prior, which saw 139 companies targeted in 166 campaigns.

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[115] See, for example, Paula Loop, Catherine Bromilow and Leah Malone, *The Changing Face of Shareholder Activism*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 1, 2018), available at https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/.

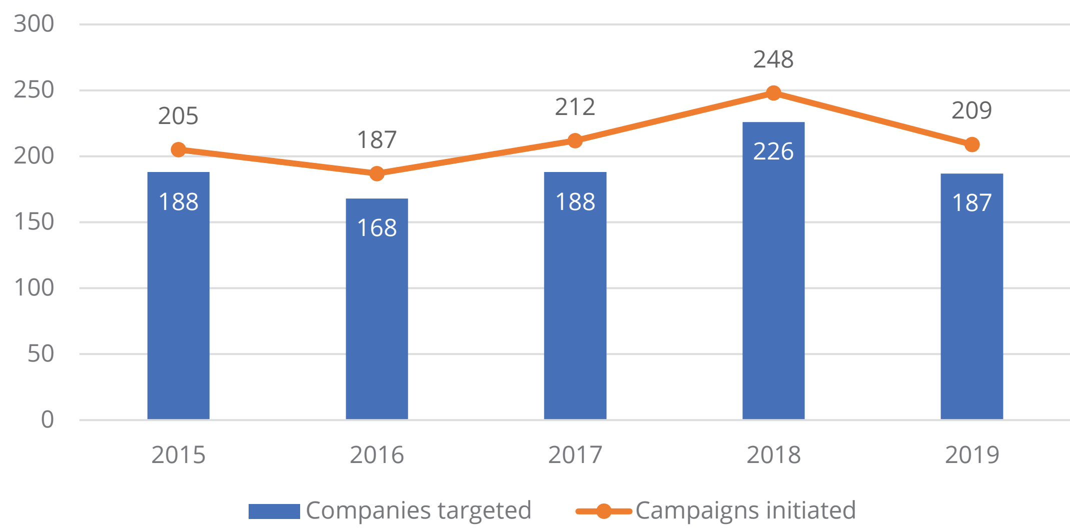
[116] See id.

[117] Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 Yale L.J. 1870, 1909 (2017).

[118] See, for example, Lucian Bebchuk, Alon Brav and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 Colum. L. Rev. 1085 (June 2015); Coffee and Palia, *The Wolf at the Door* (cited in note 27).

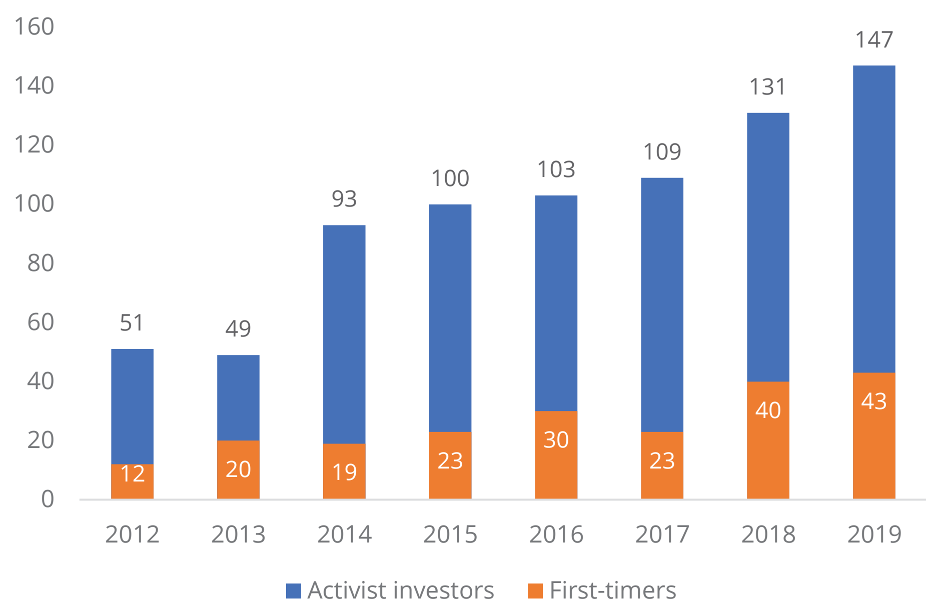
[119] See id at 7 (noting that "[a]ll studies have found that activist campaigns result *on average* in short-term gains for shareholders, but the evidence…is decidedly more mixed with respect to long-term gains.").

Figure 3. Annual campaign activity.[120]



The number of investors employing activist tactics reached record highs in 2019, as 147 investors—43 of whom were first-time activists—engaged in activist campaigns. **Figure 4** shows the annual number of investors involved in activism since 2012, including the number of first-time activists.

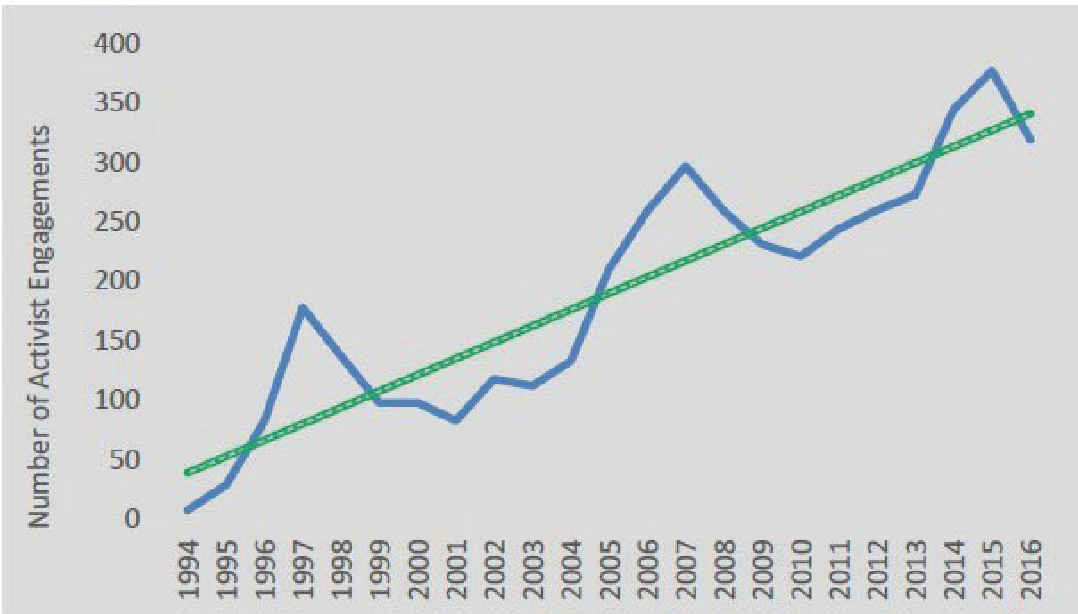
Figure 4. Investors launching activist campaigns.[121]



[120] See Shareholder Advisory Group, *2019 Review of Shareholder Activism*, Lazard 2 (Jan. 2020), available at https://www.lazard.com/media/451141/lazards-2019-review-of-shareholder-activism-vf.pdf.
[121] See id at 6.

Roe (2018) also documents the prevalence of activist engagements over time, and finds a similar trend (though he shows slightly higher figures than the Lazard report, as Roe includes target companies with a lower market capitalization than Lazard).[122] **Figure 5** shows the annual number of activist engagements from 1994 through 2016 according to Roe. While there were almost no activist campaigns in the mid-1990s, the number of campaigns rose to over 300 more recently.

Figure 5. Number of activist engagements.



b. Effects of activism

Critics of shareholder activism argue that activist intervention leads to short-term stock market gains at the expense of long-term value, whereas proponents argue that activist campaigns can revive moribund companies, improving both their short- and long-term prospects. This subsection reviews the empirical evidence of both the short-term and long-term effects of shareholder activism.

Short-term effects

While the precise magnitude of the stock price impact of activist campaigns varies by study, most studies find that stock prices experience average positive abnormal returns of six to eight percent following the announcement of an activist intervention.[123] The range of abnormal returns largely depends on the study's definition of the short-term window (the time frame over which stock returns are calculated) and the time period studied. For example, Bebchuk, Brav and Jiang (2015) find

[122] See Roe, *Stock Market Short-Termism's Impact* at 12 (cited in note 6). Lazard limits its figures to campaigns against companies with a market capitalization of $500 million or greater, while it is unclear whether the Roe data is limited by market cap. This may explain the higher Roe numbers.

[123] "Abnormal" return is the portion of the stock return in excess of the return that would be expected based on traditional factors (e.g. overall stock market factors).

abnormal returns of six percent measured over a 40-day period, from 20 days prior to the announcement of an activist campaign to 20 days after the announcement, during the period of 1994 to 2007.[124] Klein and Zur (2009) find average abnormal returns of more than seven percent in activist campaigns that occurred primarily from 2003 to 2005, measured from 30 days prior to 30 days after the announcement.[125] And Boyson and Mooradian (2011) find, in the study period of 1994 through 2005, average abnormal returns of more than eight percent, measured from 25 days prior to 25 days after the announcement of an activist campaign.[126]

Importantly, these short-term returns are *average* abnormal returns for targeted firms. Not every firm that is the target of activism experiences positive returns, even in the short run. For example, Brav et al. (2008) found that 38 percent of firms targeted by activists in the study period of 2001 through 2006 did not experience *positive* abnormal returns in the short run.[127] Likewise, Clifford (2008) reported that 37 percent of targeted firms from 1998 through 2005 experienced negative abnormal returns.[128]

While these studies focus on the U.S. stock market, the short-term benefits of activist campaigns have also been documented in non-U.S. stock markets. Becht et al. (2015), for example, show that activist interventions lead to positive abnormal stock returns in more than 20 stock markets globally.[129]

Long-term effects

Critics of activism argue that activist tactics merely provide a short-term boost to stock prices, benefiting the activists but sacrificing long-term firm value. Judge Strine, for example, has warned of the "danger that activist shareholders will make proposals motivated by interests other than maximizing the long-term, sustainable profitability of the corporation."[130] Similarly, Coffee and Palia (2016) argue that "the increasing rate of hedge fund activism is beginning to compel corporate boards and managements to forego long-term investments (particularly in R&D) in favor of a short-term policy of maximizing shareholder payout."[131]

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[124] See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* (cited in note 118).
[125] See April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. of Fin. 187 (Feb. 2009).
[126] See Nicole M. Boyson and Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism* 14 Rev. of Deriv. Res. 169 (2011).
[127] See Alon Brav, Wei Jiang, Frank Partnoy and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. of Fin. 1729 (Aug. 2008).
[128] See Christopher P. Clifford, *Value Creation or Value Destruction? Hedge Funds as Shareholder Activists*, 14 J. of Corp. Fin. 323 (Sep. 2008).
[129] See Marco Becht, Julian Franks, Jeremy Grant and Hannes Wagner, *Returns to Hedge Fund Activism: An International Study*, 30 Rev. of Fin. Stud. 2933 (Sep. 2017).
[130] Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Manage for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 Bus. Lawyer 1 (Nov. 2010).
[131] Coffee and Palia, *The Wolf at the Door* at 9 (cited in note 27).

A longstanding critic of shareholder activism, corporate attorney Martin Lipton, has argued that "the short-term influence of activist hedge funds has been, and continues to be, profoundly destructive to the long-term health of companies and the American economy."[132] His evidence is primarily anecdotal, based on "the decades of [his] and [his] firm's experience in advising corporations."[133] The empirical literature, however, paints a different picture.[134]

Several studies examine the long-term stock returns of companies targeted by activists, testing whether the short-term gains in stock price are subsequently reversed. Bebchuk, Brav and Jiang show that, during the period of 1994 to 2007, targets of activism experience average abnormal returns of 2.6 percent over the three years following activist intervention and 5.8 percent over the five years following activist intervention.[135] Klein and Zur find that target companies earned abnormal returns of 11.4 percent over the year following an activist intervention from 2003 to 2005.[136] And Greenwood and Schor (2009) find abnormal returns of 10.4 percent over the following 18 months following an activist intervention in the study period of 1993 through 2006.[137]

On the other hand, deHaan, Larcker and McClure (2019) found that on a value-weighted basis pre- and post-activism long-term returns (from one month before intervention through one to two years following intervention) insignificantly differ from zero during the study period of 1994 through 2011.[138] They found that positive gains following activist intervention were primarily driven by the smallest 20% of target firms, and that nearly all the positive long-term returns following activist interventions were concentrated among firms that were later acquired.[139]

In addition to measuring the long-term effects on stock returns, Bebchuk, Brav and Jiang also observe the long-term effects of activism on the target firm's operating performance. Their study finds

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[132] Martin Lipton, *Do Activist Hedge Funds Really Create Long Term Value?*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jul. 22, 2014), available at https://corpgov.law.harvard.edu/2014/07/22/do-activist-hedge-funds-really-create-long-term-value/.

[133] Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 26, 2013), available at http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-companywreck-the-economy/.

[134] Lipton acknowledges that econometric evidence that appear to undermine his claims, but cites Allaire and Dauphin (2014) to call into question the value of empirical studies relative to observations based on real-world experience. According to them, "[e]conometrics provides a crude tool kit, a weak lens through which the researcher can, at best, view the blurred contours of complex phenomena." See Yvan Allaire and Francois Dauphin, *"Activist" Hedge Funds: Creators of Lasting Wealth?*, Institute for the Governance of Private and Public Organizations 2 (July 2014).

[135] Based on a value-weighted buy-and-hold strategy. See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* (cited in note 118).

[136] See Klein and Zur, *Entrepreneurial Shareholder Activism* (cited in note 125).

[137] See Robin Greenwood and Michael Schor, *Investor Activism and Takeovers*, 92 J. of Fin. Econ. 362 (Jun. 2009).

[138] See Ed deHaan, David Larcker and Charles McClure, *Long-Term Economic Consequences of Hedge Fund Activist Interventions*, 24 Rev. of Acc. Stud. 436 (2019).

[139] See id at 540.

that both Tobin's Q (a commonly used measure of a firm's operating performance)[140] and the return on assets of a target company increase on average over the five years following an activist campaign.[141]

Brav, Jiang and Kim (2015) examine the impact of hedge fund activism on target company productivity in the study period of 2001 through 2006.[142] They find that productivity at manufacturing plants improves over the three years following an activist intervention. In the same vein, they find that investment in information technology increases at target companies, which is also positively associated with productivity improvements. Brav et al. argue that their empirical findings refute "the assertion that the effects of hedge fund activism are purely financial (such as extracting payouts to shareholders through leverage), as argued by some policy makers and the popular press."[143]

By contrast, Allaire and Dauphin (2015) find that companies targeted in activist campaigns in the period of 1994 through 2007 reduced average R&D spending (measured as a percentage of sales) from 17.34 percent to 8.12 percent over four years following an activist campaign.[144] Brav et al. (2018) report similar results, finding that R&D spending declines by an average of $21 million in the five years after an activist intervention between 1994 and 2007. However, they also find that the productivity of R&D, measured by patent counts and citations, improves significantly despite the reduction in spending.[145] They attribute this apparent improvement in innovation to the more efficient allocation of resources, more efficient use of labor, and changes to board-level expertise that follow activist interventions.[146]

c. Passive investors and activist strategies

The recent increase in shareholder activism has occurred against the backdrop of the rise of passive indexing as a popular investment strategy. Between 2005 and 2018, the aggregate assets held by index mutual funds and ETFs that invest primarily in U.S. equities grew more than fourfold, from $721 billion to more than $4 trillion.[147] Over the same period, the fraction of U.S. equity market

[140] See Bebchuk, Brav and Jiang, *The Long-Term Effects of Hedge Fund Activism* at 1101 (cited in note 118): "Tobin's Q is the metric most commonly used by financial economists for studying the effectiveness with which firms operate and serve their shareholders…[and] is designed to reflect a company's success in turning a given book value of assets into market value accrued to investors."
[141] See id at 1103–06.
[142] See Alon Brav, Wei Jiang and Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes*, 28 Rev. of Fin. Stud. 2723 (Oct. 2015).
[143] See id. at 2726.
[144] See Yvon Allaire and Francois Dauphin, *Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence*, Institute for the Governance of Public and Private Organizations 24 (April 2015).
[145] See Alon Brav, Wei Jiang, Song Ma and Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?* 130 J. of Fin. Econ. 237 (2018).
[146] See id at 247–56.
[147] See *2019 Investment Company Fact Book: A Review of Trends and Activities in the Investment Company Industry*, Investment Company Institute 201, 233 (2019).

capitalization held by index funds grew from 4 to 13 percent.[148] And according to estimates from Morningstar Inc., as of August 2019, assets managed by passive index funds exceed those held by active funds.[149] The growth of passive investing has been heavily concentrated at the top: since 2010, index funds controlled by the three largest asset managers have received 70 percent of cumulative inflows to index funds.[150]

Appel, Gormley and Keim (2019) study the relationship between passive ownership and activists, specifically analyzing whether the "increasingly large and concentrated ownership stakes of passive institutional investors influence the types of campaigns undertaken by activists, the tactics they employ, and their eventual outcomes."[151] They predict that the increased presence of passive institutional investors—in particular, the increased concentration of public company ownership—may facilitate activist campaigns, so long as the campaigns are focused on improving long-term value, as opposed to temporary short-term gains: "[t]he large and concentrated ownership stakes of passive institutions might help…facilitat[e] activist investors' ability to rally support for their demands…and decreas[e] the coordination costs of activism."[152]

Their prediction is borne out by their results. While they do not find a correlation between higher passive ownership and increases in the likelihood of an activist campaign,[153] they report that passive ownership does influence the strategies and outcomes of activist campaigns, as activists launch more aggressive campaigns against companies with higher passive ownership. Higher passive ownership correlates with: (i) increased likelihood of activists seeking board representation (a relatively ambitious and more costly campaign as compared to other types of campaigns);[154] (ii) increased use of

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[148] See id at 41.

[149] See John Gittelsohn, *End of Era: Passive Equity Funds Surpass Active in Epic Shift*, Bloomberg News (September 11, 2019), available at https://www.bloomberg.com/news/articles/2019-09-11/passive-u-s-equity-funds-eclipse-active-in-epic-industry-shift.

[150] See Vladyslav Sushko and Grant Turner, *The implications of passive investing for securities markets*, BIS Quarterly Review 113, 118 (March 2018).

[151] See Ian R. Appel, Todd A. Gormley and Donald B. Keim, *Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism*, 32 Rev. of Fin Stud. 2720, 2721 (July 2019).

[152] Id at 2721–22. See also Jill E. Fisch, Asaf Hamdani and Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. Pa. L. Rev. 17, 42 (2020) ("Passive funds also play a complementary role in the more focused engagement provided by hedge funds by serving as gatekeepers for activism… [H]edge funds typically purchase less than 10% of an issuer's shares and, as a result, cannot wage a successful campaign unless they have the support of institutional investors (and thus passive funds).").

[153] An earlier study by Appel, Gormley and Keim found "evidence that a larger ownership stake by passive funds is associated with a decline in hedge fund activism; a one standard deviation increase in ownership by passive mutual funds is associated with a 1.6 percentage decline in the likelihood of a hedge fund activism event (statistically significant at the 10% level)." This decline is attributed to "the engagement of passive investors reducing the need for activism by other investors." Ian R. Appel, Todd A Gormley and Donald B. Keim, *Passive Investors, Not Passive Owners*, 121 J. of Fin. Econ. 111, 114 (2016).

[154] Less ambitious campaigns include shareholder proposals and exempt solicitations. See Appel, Gormley and Keim, *Standing on the Shoulders of Giants* at 2724–26 (cited in note 151).

hostile tactics versus more friendly approaches;[155] (iii) an increase in "both the likelihood and favorability of proxy settlements with management;"[156] and (iv) an increase in the likelihood for success related to campaigns advocating for a sale of the company to a third party (i.e. not to the activist) and removal of takeover defenses.[157] Their results also suggest that the rise of passive investors facilitates activist campaigns focused on long-term changes, while having no effect on the success of activist campaigns focused on short-term objectives such as capital payouts (dividends and share repurchases) or other changes to the capital structure.[158]

[155] Hostile tactics include proxy battles against incumbent directors. See id.
[156] See id.
[157] See id.
[158] Notably, their earlier study, mentioned above, found that public companies with higher shares of ownership by passive funds demonstrated improved corporate governance measures, such as a higher number of independent directors, fewer takeover defenses and fewer dual class share structures. See Appel, Gormley and Keim, *Passive Investors, Not Passive Owners* at 114 (cited in note 153).

3. Stock buybacks

Stock buybacks are firm repurchases of stock from shareholders and, along with dividends, are a method for firms to redistribute excess capital back to shareholders. Lawmakers have recently recommended curtailing public companies' use of stock buybacks, arguing that the practice has constrained long-term investment while enriching wealthy shareholders and executives.[159]

This section begins with a discussion of the current regulatory scheme governing buybacks and a discussion of recent trends in stock buybacks and dividends by U.S. firms. It then discusses the several reasons that a firm may conduct stock buybacks, followed by an analysis of the potential long-term impact of stock buybacks on public companies. This section concludes with an analysis of the various proposals that are aimed at curtailing stock buybacks and total shareholder payouts more generally, and sets forth a recommendation to enhance the transparency of stock buyback plans.

a. Regulation of stock buybacks in the United States

Stock buybacks were not a common practice until the 1980s, as they were generally perceived to be prohibited by the Exchange Act.[160] A company purchasing its own shares could be considered manipulative and therefore liable under the Exchange Act.[161] In 1982, the SEC promulgated Rule 10b-18, which provided for a safe harbor from liability for manipulation for engaging in stock buybacks.[162]

In 2003, Rule 10b-18 was updated to "simplify and update [its provisions] … in light of market developments."[163] To make use of this safe harbor, a firm must abide by the manner (limiting the issuer to a single broker or dealer per day to bid for or purchase stock), timing (restricting purchases

[159] See, for example, Chuck Schumer and Bernie Sanders, *Schumer and Sanders: Limit Corporate Stock Buybacks*, NY Times (Feb. 3, 2019); Senators Baldwin, Schumer, Van Hollen, Schatz, and Wyden proposed amendment SA 2124 to S. 2155 (Mar. 7, 2018), available at https://www.congress.gov/amendment/115th-congress/senate-amendment/2124; Letter to SEC Commissioner Jay Clayton signed by Senators Tammy Baldwin, Richard Blumenthal, Sherrod Brown, Cory A. Booker, Kirsten Gillibrand, Edward J. Markey, Jack Reed, Charles E. Schumer, Chris Van Hollen, Mark Warner, Elizabeth Warren, Sheldon Whitehouse, and Ron Wyden (Jun. 28, 2018); U.S. Senate Committee on Small Business & Entrepreneurship, *Made in China 2025 and the Future of American Industry*, available at https://www.rubio.senate.gov/public/_cache/files/d1c6db46-1a68-481a-b96e-356c8100f1b7/3EDECA923DB439A8E884C6229A4C6003.02.12.19-final-sbc-project-mic2025-report.pdf.

[160] See Financial Services Committee Majority Staff, *Memorandum - October 17, 2019 Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing Entitled: "Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment"*, United States House of Representatives Committee on Financial Services (Oct. 11, 2019), available at https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-20191017-sd002-u1.pdf.

[161] See Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 Calif. Law Review 1323 (2005).

[162] See id.

[163] Securities and Exchange Commission, *Purchases of Certain Equity Securities by the Issuer and Others*, 68 Fed. Reg. 64952 (Nov. 17, 2003).

during the opening and closing 30 minutes of trading), price (specifying the highest price an issuer may bid or purchase stock) and volume conditions (limiting purchases in an amount up to 25% of average daily trading volume),[164] which are intended "to minimize the market impact of the issuer's repurchases, thereby allowing the market to establish a security's price based on independent market forces without undue influence by the issuer."[165]

As a general matter, companies are required to disclose certain material events on Form 8-K within four days of their occurrence, but only if they fall into a specific item listed on the form.[166] Stock repurchase programs are not a specific item on Form 8-K, so their disclosure is not required.[167] However, companies may *elect* to disclose other material events on Form 8-Ks not otherwise required to be immediately disclosed.[168] Therefore, some companies promptly disclose the approval of stock repurchase programs, including their size and occasionally their intended duration, on Form 8-Ks under Item 8.01.[169]

Separately, NASDAQ and NYSE require the immediate disclosure of certain material information.[170] Under NASDAQ Rule 5250(b)(1), a listed company must "make prompt disclosure to the public through any Regulation FD compliant method (or combination of methods) of disclosure of any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions."[171] Likewise, under NYSE rules, "a listed company is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities."[172] These obligations are generally understood to capture the adoption of repurchase programs, but they do not require the disclosure of specific program details like intended duration and authorized amount.[173] Moreover, they can be satisfied by any disclosure "reasonably designed to provide broad, non-exclusionary distribution of the information to the public."[174] In addition to Form 8-Ks, this can include press releases, conference calls, webcasts, and posts

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[164] See id.
[165] See id.
[166] See Form 8-K, Item 8.01.
[167] See id, Item 1.01.
[168] See id, Item 8.01 ("The registrant may, at its option, disclose under this Item 8.01 any events, with respect to which information is not otherwise called for by this form, that the registrant deems of importance to security holders.").
[169] See, for example, Vaalco Energy, Inc., *Current Report on Form 8-K* (June 20, 2019https://www.sec.gov/Archives/edgar/data/894627/000089462719000038/egy-20190620x8k.htm; Eagle Pharmaceuticals, Inc., *Current Report on Form 8-K* (Oct. 30, 2018), https://www.sec.gov/Archives/edgar/data/827871/000110465918064476/a18-38166_18k.htm.
[170] See NASDAQ Rule 5250(b)(1); NYSE Listed Company Manual, Rule 202.05.
[171] NASDAQ Rule 5250(b)(1).
[172] NYSE Listed Company Manual, Rule 202.05.
[173] See Jesse M. Fried, *Insider Trading Via The Corporation*, U. Penn. L. Rev. 801 (2014).
[174] 17 C.F.R. § 243.101(e)(2)("An issuer shall be exempt from the requirement to furnish or file a Form 8-K if it instead disseminates the information through another method (or combination of methods) of disclosure that is reasonably designed to provide broad, non-exclusionary distribution of the information to the public.").

to the company's website.[175]

Periodic SEC reporting requirements oblige companies to disclose certain material details of repurchase programs. Quarterly reports must include a description of stock repurchase programs to the extent that they are material.[176] Public companies are also required to disclose certain repurchase activity in their quarterly and annual reports for any publicly announced share repurchase programs.[177] These details include, by month:

(a) the total shares repurchased,

(b) the average price paid,

(c) the total number of shares to be repurchased; and

(d) the maximum number (or dollar value) of shares that may be purchased.[178]

Public companies must also disclose:

(1) the date of announcement,

(2) the expiration date of such program or plan, if any,

(3) each program or plan that has expired during the applicable quarter, and

(4) each program or plan the firm has decided to terminate prior to expiration or which the firm does not intend to make any further purchases under.[179]

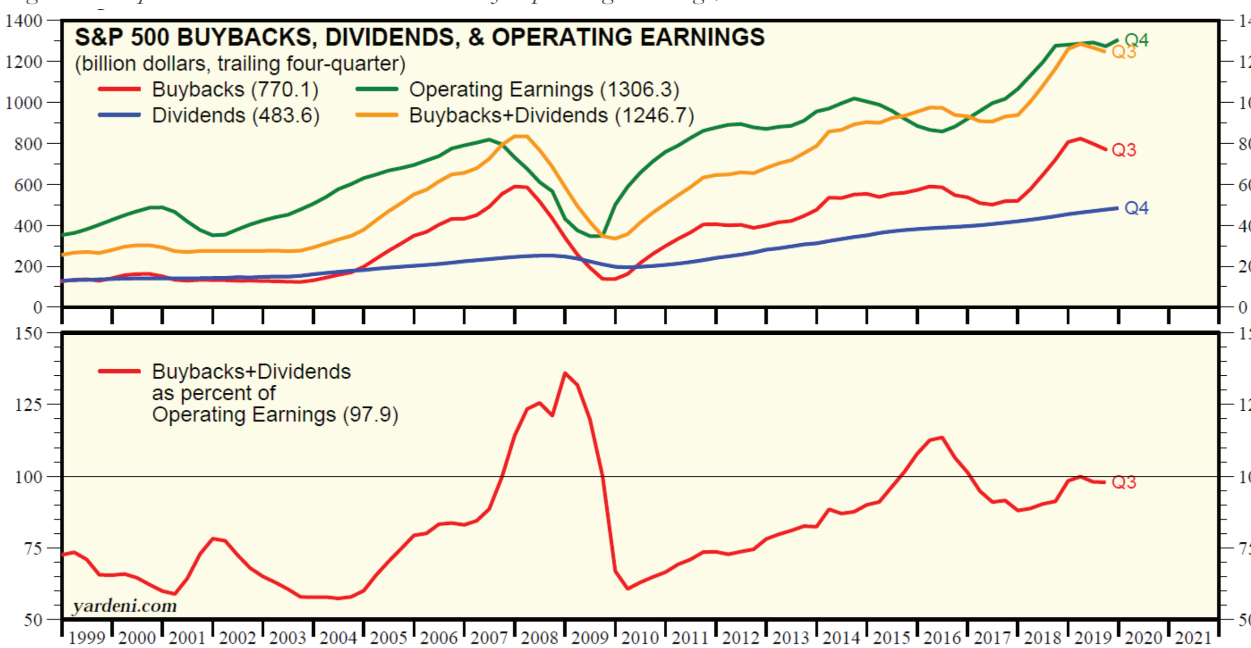
b. Data on total payouts

Stock buybacks and dividends are near all-time highs. **Figure 6** (top panel) illustrates quarterly stock buyback and dividend data for S&P 500 companies since 1999.[180] As of the third quarter of 2019, total payouts from S&P 500 companies reached $1.18 trillion over the previous four quarters, consisting of $770 billion in stock buybacks and $478 billion in dividends. From 1999 to 2019, the operating earnings of these companies more than tripled to roughly $1.3 trillion annually. This rise largely traces the corresponding increase in dividends and buybacks over the same period. As a result, the increase in distributions is largely consistent with growing profits and cannot be *primarily* attributed to an increased preference by public companies to distribute capital to shareholders.

[175] See, for example, NYSE Listed Company Manual, Rules 202.05, 204.00.
[176] See 17 C.F.R. §229.703.
[177] See Fried, *Informed Trading and False Signaling with Open Market Repurchases* at 1340-1341 (cited in note 161).
[178] See 17 CFR § 229.703.
[179] See id.
[180] See Edward Yardeni, Joe Abbott, and Mali Quintana, *Corporate Finance Briefing: S&P 500 Buybacks, & Dividends*, Yardeni Research, Inc., 10 (April 2, 2020), https://www.yardeni.com/pub/buybackdiv.pdf.

However, as shown in **Figure 6** (bottom panel), stock buybacks and dividends have also risen as a percentage of operating earnings in recent decades, from about 75% in 1999 to 98% in the third quarter of 2019.[181] Thus, those who assert that public companies are paying out a greater share of their earnings to shareholders in Q3 2019 as compared to two decades ago are in fact correct. However, the percentage of net income paid out to shareholders today is lower than it was from 2007-2009 (see **Figure 6**, bottom panel).

Figure 6. Buybacks and Dividends as a Share of Operating Earnings, 1999-2019.



Several studies have more comprehensively examined the relationship between payouts and earnings, reaching divergent conclusions. Lazonick (2014) calculates total payouts, including stock buybacks and dividends, as a percentage of net income for S&P 500 firms between 2003-2012, finding that 91% of aggregate net income was distributed to shareholders, 54% through buybacks and 37% through dividends.[182] Advocates of restricting stock buybacks cite this figure as evidence that firms are "restrain[ing] their capacity to reinvest profits more meaningfully in the company" since such a high percentage (nearly all) of profits are distributed to shareholders.[183] However, subsequent empirical research has identified significant flaws in this oft-cited statistic.

Fried and Wang (2018) study S&P 500 firms between 2007-2016 and also find a relatively high percentage of net income distributed as shareholder payouts at 96%.[184] However, that finding, like those

[181] See id.
[182] See Lazonick, *Profits without Prosperity* (cited in note 24).
[183] Schumer and Sanders, *Limit Corporate Stock Buybacks* (cited in note 159).
[184] See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25). A more detailed analysis of the data can be found in Jesse M. Fried and Charles Y. Wang, *Short-Termism and Capital Flows*, 8 Rev. of Corp. Fin. Stud. 207 (March 2019).

of Lazonick (2014), considers *gross* payouts (i.e. total capital that flows *out* of the corporation through dividends and buybacks), while ignoring capital inflows that replace distributed capital. Therefore, it excludes the capital that managers obtain from new investors for investment. The more appropriate measure is *net* payouts, which also accounts for the significant amount of new capital flowing into corporations through new equity issuances and invested in the business. Fried and Wang (2018) find that, between 2007-2016, net payouts among S&P 500 firms constituted only 50% of net income, far less than the 91% statistic frequently cited.[185] Moreover, because smaller firms outside the S&P 500 are more often capital importers compared to larger peers, net payouts at *all* public companies constituted a lesser 41% of net income over the period.[186]

Taken together, these findings indicate that although managers choose to distribute a substantial proportion of earnings, they also raise large sums of new capital, lowering their net payout ratio and equipping them with significant sums of capital for investment.

c. Motivations for stock buybacks

Critics of current stock buyback practices argue that buybacks are motivated by management's short-term goals, such as increasing earnings per share (EPS) and stock price, at the expense of investment in innovation and long-term growth.[187] It is therefore important to understand the various motivating factors for stock buyback programs, as many are unrelated to short-termism.

Most importantly, stock buybacks are an alternative method for distributing cash to shareholders that would otherwise be paid as dividends.[188] Management may prefer stock buybacks over dividends for several reasons. First, stock buybacks offer tax advantages for shareholders, since dividends are immediately taxable at ordinary income rates, while stock buybacks allow shareholders to defer tax—they can choose to hold onto their shares, rather than sell—and pay capital gains rates.[189] Second, stock buyback programs offer more flexibility than dividends, allowing management to appropriately time repurchases and adjust payouts in response to investment opportunities and accommodate impacts on earnings-per-share or stock valuation.[190] Stock buybacks are also preferable for employees since they do not entail stock price declines as occurs with dividends and therefore do not devalue

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[185] See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

[186] See id.

[187] See, for example, Lazonick, *Profits without Prosperity* (cited in note 24); Schumer and Sanders, *Limit Corporate Stock Buybacks* (cited in note 159).

[188] See generally Michael J. Brennan and Anjan V. Thakor, *Shareholder Preferences and Dividend Policy*, 45 J. of Fin. 993 (Sep. 1990); Utpal Bhattacharya and Stacey E. Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence*, 20 Rev. of Fin. 725, 725–29 (March 2016).

[189] Under current federal tax law, ordinary income tax rates on dividends generally are equivalent to capital gains rates, so the deferral of taxes is the greater advantage for buybacks over dividends. See 26 USC § 1(h)(11).

[190] See Alon Brav, John R. Graham, Campbell R. Harvey and Roni Michaely, *Payout Policy in the 21st Century*, 77 J. of Fin. Econ. 483, 501–03 (Sep. 2005).

employee stock options.[191] Stock buybacks may also signal firm value to the market, since firms typically repurchase shares that management views as undervalued.[192] In a survey of CFOs, Brav et al. (2005) note that 85% believe that stock buybacks do indeed convey positive information to shareholders.[193]

Finally, another motivating factor for stock buybacks is to lower overall costs of capital by replacing equity with debt.[194] A new issuance of debt is preferable from a tax perspective, as the interest payments are tax deductible and result in a lower tax burden.[195] Roe (2018) notes that stock buybacks have increased when interest rates are low and have declined when interest rates have increased, which is consistent with the argument that firms engage in buybacks to recapitalize their balance sheet with relatively cheaper debt.[196]

None of the above motivating factors are short term in nature. In contrast, the use of stock buybacks solely to boost the firm's EPS or price would entail a short-term focus on the part of management. Two questions arise in analyzing these possible short-term motivations for stock buybacks. What is the effect of stock buybacks on EPS and stock price? And what is the evidence that management uses buybacks for these short-term purposes?

Effect of stock buybacks on EPS and stock price

Hribar, Jenkins and Johnson (2006) note that the effect of stock buybacks on EPS is "determined by three factors: the timing of the repurchase, the proportion of shares bought back, and the financial return forfeited on the funds used to buy back shares."[197] EPS may increase or decrease depending on the overall weight of the first two factors versus the third factor. In their study, Hribar et al. report that reductions in EPS of one cent or more (21.1% of cases) are more likely than increases of one cent or more (only 9.34% of cases). In the remaining 70% of cases, buybacks result in no meaningful

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[191] See Kathleen M. Kahle, *When a buyback isn't a buyback: Open market repurchases and employee options*, 63 J. of Fin. Econ. 235 (2002).

[192] See Bhattacharya and Jacobsen, *The Share Repurchase Announcement Puzzle* (cited in note 188); Richard G. Sloan and Haifeng You, *Wealth Transfers via Equity Transactions*, 118 J. of Fin. Econ. 93 (Oct. 2015) (quantifying the magnitude of wealth transfers from selling shareholders to ongoing shareholders).

[193] See Brav et al., *Payout Policy in the 21st Century* at 511–13 (cited in note 190).

[194] See Clifford Asness, Todd Hazelkorn and Scott Richardson, *Buyback Derangement Syndrome*, 44 J. of Port. Mgmt. 50, 52 (Spring 2018) ("A considerable portion of the recent share repurchase activity has simply been a recapitalization, shifting from equity to debt. Given low real and nominal rates, it is quite possible that corporate treasurers view debt financing as cheaper than equity financing and thus engaged in this swap."); Roe, *Stock Market Short-Termism's Impact* at 24 (cited in note 6) ("Substituting debt for equity… is not the *short-term* destruction of the firms' cash for investment. It is a recapitalization from equity to debt when long-term debt is cheap.").

[195] See Asness et al., *Buyback Derangement Syndrome* at 53 (cited in note 194) ("[B]ecause interest payments are tax deductible, debt-financed repurchases can be viewed as good news because of the resulting lower tax burden.").

[196] See Roe, *Stock Market Short-Termism's Impact* at 22 (cited in note 6).

[197] Paul Hribar, Nicole Thorne Jenkins and W. Bruce Johnson, *Stock Repurchases as an Earnings Management Device*, 41 J. of Acc. and Econ. 3, 6 (2006).

impact on EPS.[198] On the other hand, Almeida, Fos and Kronlund (2016) find that firms that are at risk of missing EPS forecasts in a given quarter are 5-10% more likely to engage in stock buybacks that *increase* EPS.[199] Therefore, while any given stock buyback may increase or decrease EPS, buybacks motivated by short-term EPS goals have been found to increase EPS.

Evidence that management engages in buybacks for short-term goals

In their survey of CFOs, Brav et al. (2005) find that 75% of CFOs claim that increasing EPS is an "important" or "very important" factor in stock buyback decisions.[200] In addition, Cheng, Harford and Zhang (2015) analyze CEO bonus structures, finding that "when a CEO's bonus is directly tied to EPS, his company is more likely to conduct a repurchase and the magnitude of the repurchase tends to be larger."[201] The study further determines that when CEO bonuses are tied to EPS, share buybacks increase CEO bonuses by approximately 34%.[202] Similarly, Kim and Ng (2018) find that management is more likely to conduct a stock buyback if their stock's EPS is slightly below the bonus threshold in their compensation agreement.[203] SEC research also found that executives are twice as likely to sell shares in the eight days following a buyback program announcement compared to an ordinary trading day.[204] We therefore find evidence that stock buybacks may be used to support certain short-term goals, such as increases in executive compensation.

d. Stock buybacks and long-term investment

Regardless of the motivations for stock buybacks, whether short term in nature or not, empirical research shows that companies' aggregate investment in long-term projects remains strong. In fact, Fried and Wang (2018) show that as of the end of 2016, when total stock buybacks had hit record highs, research and development (R&D) spending as a percentage of total revenue by S&P 500 firms was also at record highs.[205] Moreover, total investment spending, measured as R&D plus capital expenditures (CAPEX) as a percentage of revenue, was also at its highest level in two decades.[206] More recently, despite stock buybacks hitting another record high in 2018, S&P 500 firms increased

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[198] See id at 12.

[199] See Heitor Almeida, Vyacjeslav Fos and Mathias Kronlund, *The Real Effects of Share Repurchases*, 119 J. of Fin. Econ. 168, 174 (Jan. 2016).

[200] See Brav et al., *Payout Policy in the 21st Century* at 515 (cited in note 190).

[201] Yingmei Cheng, Jarrad Harford, and Tianming Zhang, 50 *Bonus-driven Repurchases*, 50 J. of Fin. and Quant. Analysis 447, 448 (June 2015).

[202] See id at 468.

[203] See Sunyoung Kim and Jeff Ng, *Executive Bonus Contract Characteristics and Share Repurchases*, 93 Acc. Rev. 289 (Jan. 2018).

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

[205] See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

[206] See id.

CAPEX and R&D spending by 13%.[207] The concern, however, is that R&D spending would have increased even more if capital had not been allocated to stock buybacks, but the record cash balances at S&P 500 firms suggest otherwise. Even after accounting for the $800 billion in stock buybacks in 2018, S&P 500 firms still held an aggregate of $1.4 trillion in cash at the end of the year.[208] This data indicates that stock buybacks have not depleted public companies of their resources available for investment in long-term growth, but rather public companies simply have "more capital than they need for the investment opportunities available."[209]

While aggregate levels of investment have not appeared to suffer with the rise in total stock buybacks, another relevant question is whether stock buybacks affect investment spending at the individual firm level, rather than in aggregate. A recent MSCI study looks at the link between stock buybacks and investment spending at the firm level, finding that contrary to the concerns of stock-buyback critics, companies that are the most actively engaged in stock buybacks are also the strongest in terms of R&D and CAPEX spending.[210] The study concludes there is "[no] evidence that companies might be diverting resources to buybacks instead of reinvesting in their companies."[211] Similarly, Kay and Martin (2019) found that companies that participate in larger share buybacks had higher CAPEX spending over the four years after the buyback.[212] Yet another link at the individual firm level is the fact that the ten S&P 500 firms that accounted for two-thirds of the increase in buybacks in 2018 also increased total investment in R&D and CAPEX by 26% that year.[213]

Finally, even if individual firms were to divert cash from investment spending for use in buybacks, that cash is not necessarily withdrawn from the capital markets. The capital that shareholders receive from buybacks can be invested in other companies that can use the funding in more productive ways. In this case, instead of stock buybacks draining investment capital from the economy, buybacks free up capital to be deployed more productively. For example, while the largest public companies have experienced net outflows of capital over the past decade, smaller public growth companies have experienced net inflows of over $400 billion from 2007-2016.[214] Roe (2018) argues that

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[207] See David Kostin and Cole Hunter, *Buyback Realities: Debunking buybacks myths*, 77 Top of Mind: Goldman Sachs Global Investment Research 4 (April 11, 2019), available at https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf .

[208] See Peter Brennan, *S&P 500 share buybacks could reach $1 trillion in 2019 on swollen cash piles*, S&P Global Market Intelligence (Mar. 26, 2019), available at https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/50751184.

[209] Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

[210] See Ric Marshall, Panos Seretis and Agnes Grunfeld, *Taking Stock: Share Buybacks and Shareholder Value*, MSCI 17 (Aug. 2018), available at https://www.msci.com/documents/10199/ba01b4c4-683c-74ca-339e-f422df5d879e.

[211] Id.

[212] See Ira Kay and Blaine Martin, *Are Share Buy Backs a Symptom of Managerial Short-Termism?*, Harvard Law School Forum on Corporate Governance (May 18, 2019), available at https://corpgov.law.harvard.edu/2019/05/18/are-share-buybacks-a-symptom-of-managerial-short-termism/.

[213] See Kostin and Hunter, *Buyback Realities* at 4 (cited in note 207).

[214] See Fried and Wang, *Are Buybacks Really Shortchanging Investment?* (cited in note 25).

recent data shows that cash is flowing from larger firms, including those participating in largescale buybacks, to smaller firms that may be better suited to drive innovation.[215] In addition, Steil and Rocca (2019) show that it is the companies with the least productive use for excess cash, as measured by average return on capital, that constitute a majority of buyback activity.[216] Because of this, buybacks may actually mitigate *overinvestment* problems by returning capital to shareholders in cases where productive uses of capital are scarce,[217] and avoiding so-called empire building, whereby managers deploy excess cash in projects simply to increase the size of the firm that they manage, even if the projects are poor investments.[218]

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[215] See id.

[216] See Benn Steil and Benjamin Della Rocca, *Why Schumer and Sanders Are Wrong on Buybacks*, Council on Foreign Relations Blog (Feb. 15, 2019) (finding that "the three sectors experiencing the largest decline in return on capital – IT, Health Care, and Energy – account for nearly *80 percent of the rise in buyback activity* in the first half of last year."), available at https://www.cfr.org/blog/why-schumer-and-sanders-are-wrong-buybacks.

[217] See Dennis Oswald and Steven Young, *Share reacquisitions, surplus cash, and agency problems*, 32 J. of Bank. and Fin. 795 (May 2008).

[218] See, for example, Asness et al., *Buyback Derangement Syndrome* at 53 (cited in note 194) (noting that "[t]his kind of agency cost is often characterized as empire building, and avoiding it has long been viewed as one of the benefits of returning cash to shareholders.").

4. Conclusions and recommendations

Advocates of the short-termism thesis have argued that public companies take actions to increase their short-term stock price at the expense of long-term investment, which, in turn, will negatively impact economic growth and job creation economy-wide. While surveys of public company executives have shown an increase in short-term pressure, there is limited empirical evidence showing that executives are acting on these pressures or that short-termism is harming the economy. Empirical studies have not shown an economy-wide decline in long-term investment by public companies.

An important consideration for public companies is the potential consequences of issuing quarterly earnings guidance. Our research shows mixed results on the link between such guidance and short-term pressures, suggesting that any mandatory restrictions on quarterly earnings guidance would be inappropriate. On the one hand, there is some empirical evidence that firms issuing quarterly earnings guidance are more likely to attract short-term investors and, thus, invest less in long-term growth. On the other hand, contrasting studies find that ceasing quarterly earnings guidance not only fails to increase long-term investment spending, but can also lead to higher costs of equity capital for firms. As a result, the decision to issue quarterly earnings guidance is best left to individual firms who should give consideration to the costs and benefits of such guidance.

The rise of shareholder activism and the increase in stock buybacks by public companies have been criticized as exacerbating short-termism, by either causing companies to focus on short-term stock prices at the expense of long-term value to appease activists or as a method to boost stock prices in the short-term by engaging in stock buybacks. We find that the majority of empirical literature regarding the short-term impact of activism on public companies is positive and the evidence regarding long-run effects of shareholder activism is ambiguous. We therefore do not recommend any regulatory changes to reduce the role of shareholder activism in U.S. capital markets. As to stock buybacks, we find that although stock buybacks have been increasing, long-term investment remains strong. However, firms are subject to limited disclosure requirements with respect to stock buyback programs. The SEC could facilitate additional transparency by enhancing their existing disclosure regime for share repurchase programs.

In light of these findings, the Committee on Capital Markets Regulation recommends the following reforms:

- U.S. public companies should weigh carefully the costs and benefits of quarterly earnings guidance and consider ending the practice if it discourages them from committing to long-term investments.

- The SEC should issue precatory guidance clarifying that companies should publicly disclose certain material elements of a stock buyback program after authorization by a company's Board of Directors. Such material elements should include the maximum repurchase amount of shares (number of shares and total dollar value) and the approximate intended duration of the plan. Public companies should publicly disclose such elements within five business days of the authorization of a stock buyback plan. Public companies should be permitted to provide public disclosure through press releases or other Reg FD-compliant methods that ensure broad public dissemination.

COMMITTEE ON CAPITAL MARKETS REGULATION

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