Nothing But The Facts:

Restricting Stock Buybacks Would Harm U.S. Capital Markets

Recent policy proposals put forth by several lawmakers have recommended curtailing public companies' use of stock buybacks, arguing that the practice has constrained economic growth while unfairly enriching wealthy shareholders and executives.[1] However, these proposals have offered no empirical or theoretical support for their recommendations and we are aware of no such evidence. The Committee on Capital Markets Regulation ("**Committee**") is further concerned that the arguments offered in support of such proposals are premised on myths about stock buybacks and its effects. In this statement, the Committee seeks to clarify a few key points on this issue.

Myth #1: Stock buybacks have led to a reduction in investment and innovation by corporations.

This myth frequently serves as the cornerstone of the arguments against stock buybacks[2] with advocates for restricting stock buybacks contending that "more than 90 percent of corporate profits" go to stock buybacks and dividends.[3] However, this statistic considers only gross payouts over the given time period (2008-2017), ignoring all new equity issuances that partially offset the buybacks. Looking at a similar time period (2007-2016), academics have found that while *gross* payouts for S&P 500 companies constituted 96% of profits, *net* payouts (i.e. including new equity issuances) totaled only 50%.[4]

Second, R&D spending by S&P 500 firms has recently hit record highs.[5] And a recent MSCI study finds "[no] evidence that companies might be diverting resources to buybacks instead of reinvesting in their companies."[6] On the contrary, companies that are the most actively engaged in buying back stock are also the strongest in terms of R&D and capital expenditures (CAPEX).[7] In

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[1] *See e.g.* Senators Chuck Schumer and Bernie Sanders, *Schumer and Sanders: Limit Corporate Stock Buybacks*, NY Times Op-Ed, Feb. 3, 2019; *and see e.g.* Senators Baldwin, Schumer, Van Hollen, Schatz, and Wyden proposed amendment SA 2124 to S. 2155, Mar. 7, 2018, available at https://www.congress.gov/crec/2018/03/07/CREC-2018-03-07-pt1-PgS1462.pdf; *and see e.g.* 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, dated Jun. 28, 2018; *and see e.g.* Report by 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.

[2] Schumer and Sanders state that "[w]hen corporations direct resources to buy back shares…they restrain their capacity to reinvest profits more meaningfully in the company…."; the Democratic Senators letter states "[t]he explosion of stock buybacks has funneled corporate profits to wealthy shareholders and corporate executives instead of worker and long-term investments that spur sustained economic growth."

[3] Schumer and Sanders 2019.

[4] *See* Jesse M. Fried & Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment*, Harvard Business Review, Mar-Apr 2018.

[5] *Id*.

[6] Ric Marshall, Panos Seretis & Agnes Grunfeld, *Taking Stock*, MSCI, Aug. 2018.

[7] Id. at 23.

addition, recent research shows that aggregate investment by public companies has increased dramatically since the financial crisis.[8]

Finally, the claim that investment is constrained by stock buybacks (or dividends) also fails to consider an important fact: cash that is distributed to shareholders through stock buybacks is not 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. As a result, stock buybacks do not represent the draining of investment capital from the economy, but quite on the contrary, buybacks free up capital to be used in more productive ways, thus creating jobs and economic growth. 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.[9] In this way, stock buybacks serve an important function in the efficient allocation of capital.

Myth #2: Restricting stock buybacks would stimulate growth and create jobs.

The corollary to myth #1 is that limiting or restricting buybacks, as proposed by several legislators, would boost economic growth and create jobs. However, while it may be the case that requiring management to invest in relatively less productive ventures may temporarily create jobs at a specific company, it will deprive investors from employing that capital in more productive ways. Indeed, academic research has found that stock buybacks help mitigate *overinvestment* problems by returning capital to shareholders in cases where productive uses of the capital are scarce.[10] Such overinvestment not only prevents shareholders from reallocating the cash to more productive investments, but also it can lead to "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.[11] The data on stock buybacks clearly shows that it is precisely the companies with the *least* productive use for excess cash that constitute a majority of buyback activity.[12] These are the companies that *should* be returning underperforming capital to shareholders, not engaging in the overinvestments that would occur under these proposals.

Myth #3: Stock buybacks increase shareholder wealth.

When a corporation earns profits, claims to those profits belong to shareholders irrespective of whether the profits are retained on the corporation's balance sheet or distributed to shareholders through stocks buybacks or dividends. Because of this, stock buybacks themselves do not *create* value for shareholders, but rather *transfer* pre-existing value from one pocket (the corporation's

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[8] Asness, Hazelkorn, and Richardson, *Buyback Derangement Syndrome*, Journal of Portflio Management, Spring 2018.

[9] Fried & Wang 2018.

[10] *See e.g.* Oswald and Young, *Share reacquisitions, surplus cash, and agency problems*, Journal of Banking and Finance, 2008.

[11] *See e.g.* Asness, Hazelkorn, and Richardson, *Buyback Derangement Syndrome*, Journal of Portflio Management, Spring 2018 (noting that "[t]his kind of agency cost is often characaterized as empire building, and avoiding it has long been viewed as one of the benefits of returning cash to shareholders.")

[12] *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.")

balance sheet) to another (the shareholder). While a firm may appear more profitable on a per share basis and the price of stock may temporarily increase, this is true for all shareholders, including 401k's and pension plans, not just the very wealthy.

Of course, value can be created more indirectly since stock buybacks contribute positively to the efficient allocation of capital. As noted above, since shareholders can reinvest the capital in more productive ventures, overall wealth of investors can be increased. But this is a *feature* of stock buybacks, not a bug. Firm management and boards should prioritize investor returns and, therefore, should distribute excess cash to shareholders if the firm does not have a productive use for it. Disrupting this feature of capital markets – i.e. the distribution of profits to shareholders, which is the foundation of capital markets – would harm workers' pension funds and retirement accounts, including 401k's. Even worse, restricting the distribution of profits that shareholders are rightfully entitled to would chill investment in the first place, thus depriving firms of needed capital and negatively impacting economic growth and job creation economy-wide.

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We note that many critics of stock buybacks argue that stock buybacks are used to increase earnings per share and stock price to increase executive compensation.[13] The Committee has not taken a position on the appropriate levels of executive compensation in the past, however in general we believe that executive compensation is a corporate governance issue best left to boards and shareholders. Moreover, restricting stock buybacks would be an ineffective method of addressing concerns regarding excessive executive compensation as doing so would simply limit one source of compensation. Concerns have also been expressed that investors may lack material information as to the timing and size of stock buybacks, because public companies are only required to disclose their stock buybacks on a quarterly basis.[14] Such concerns could be addressed through more timely disclosure requirements of stock buybacks, by for example requiring companies to disclose their stock buybacks two days after they occur as individual insiders presently must do.[15]

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Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Prof. Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

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[13] Dividends dilute the per-share value of stock, while stock buybacks do not, so executive compensation linked to share price (e.g. stock options with a strike price that is not dividend-adjusted) will be higher with buybacks. *See e.g.* Bhattacharya and Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence*, Rev. of Finance, 2016; *and see* William Lazonick, *Profits without Prosperity*, Harvard Business Review, Sep. 2014 (noting that "[s]tock based instruments make up a majority of [executives'] pay, and in the short term buybacks drive up stock prices.")

[14] *See* Jesse Fried, *Insider Trading Via The Corporation*, Univ. of Penn. Law Review, No. 4, 2014.

[15] *Id.*