PAY FOR DESTRUCTION: THE EXECUTIVE COMPENSATION ARRANGEMENTS THAT ENCOURAGE VALUE-DECREASING STOCK BUYBACKS

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ABSTRACT

Previous studies by myself and other scholars have shown that stock buybacks can increase executive compensation by altering ratings on performance yardsticks that determine bonuses and stock awards. In this article, I argue that executives' incentives to conduct buybacks for this purpose are undesirable, as they encourage stock buybacks that destroy firm value and separate pay from performance. Because commonly used performance yardsticks, which are designed to measure the impact of ordinary business decisions on firm value, fail to properly reflect the intertemporal, financial, and stock trading impact of stock buybacks on firm value, they invite various forms of abuse. Specifically, I show that stock buybacks that shortchange long-term value can improve earnings per share (EPS), that buybacks that excessively increase a firm's financial risk can elevate EPS and total shareholder return (TSR), and that buybacks that manipulate the stock price can lift TSR. My empirical inquiry indicates that these incentives matter because such performance criteria determine almost one third of S&P 500 CEO total pay. My analysis related to stock buybacks is especially troubling, because it shows that the executive compensation reforms undertaken to alleviate the systemic problems highlighted by the financial crisis of 2008–2009 have exacerbated those problems instead. I explain the corporate governance failures that enable corporate executives to act on their undesirable buyback incentives, and I propose regulatory reforms that would make the impact of stock buybacks on executive compensation transparent and empower shareholders to opine on this information in their advisory "Say on Pay" voting. My proposed reforms can be expected to push boards and shareholders to remedy the flaws inherent in the design of performance metrics affected by stock buybacks.

Keywords: corporate payout, stock buybacks, financing policy, corporate governance, corporate law, executive compensation, executive pay, equity-based compensation, agency costs.

JEL Classification: G35, G32, G34, G38, K22

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* Full Professor, Peking University School of Transnational Law. I am grateful to Gilad Abiri, Jesse Fried, Sara Gerke, Ehud Kamar, Yair Listokin, Haggai Schreiber, Dan Weiss, the participants at the Finance and Accounting PhD seminar at Freie Universität Berlin, the participants at the Law and Economics seminar at Tel Aviv University Law School, and the participants at the Canadian Law and Economics Association conference for helpful comments. I would also like to thank Equilar Inc., an executive compensation research firm, for providing complimentary use of its reports. Gili Bartura and Sebastian Preissner provided excellent research assistance.

INTRODUCTION

We are living through a stock buyback revolution.[1] Over the last decade, the amount that U.S. public firms have spent on buying back stock from their shareholders has risen threefold to a record level of roughly $1 trillion in each of 2018 and 2019.[2] By the end of 2019, the scale of buyback activity had increased to the point that total shareholder payouts (stock buybacks and dividends together) took up the full amount of corporate earnings.[3] After a pandemic-related pause in 2020, the buyback wave is roaring to life again.[4]

The economic and financial importance of stock buybacks has sparked a vibrant debate among prominent economists, lawyers, business leaders, and politicians over their desirability. Senior academics, including Michael Jensen and Jesse Fried, and leading business figures such as Warren Buffet and Lloyd Blankfein, have justified buybacks as a means to reduce managerial agency costs,[5] signal undervaluation of a company stock,[6] and improve capital allocation.[7] Other academics, including William Lazonick, and leading Democratic senators,

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[1] *See The Repurchase Revolution*, THE ECONOMIST (Sept. 12, 2014), https://www.economist.com/business/2014/09/12/the-repurchase-revolution.

[2] *See* GOLDMAN SACHS, *Top of Mind, Buyback Realities*, Issue 77, p. 14 (Apr. 11, 2019), https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf (indicating that in 2018, roughly $1.1 trillion in repurchases were authorized, with about $900 billion actually repurchased). *See* Jesse Pound, *Goldman Has a Big Worry Heading into 2020 That Could Cause Market Turmoil*, CNBC (Dec. 16, 2019), https://www.cnbc.com/2019/12/16/goldman-has-a-worry-could-hit-earnings-cause-volatility-in-2020.html (indicating that Goldman Sachs estimates that although buybacks declined by 15% in 2019, total buybacks last year were the second highest on record).

[3] *See* Jesse M. Fried & Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment?*, HARV. BUS. REV. (2018) (reporting that the ratio of dividends and stock repurchases to net income is high, reaching 96% during the period 2007–2016); also *see* Robert Ayres & Michael Olenick, *Secular Stagnation (Or Corporate Suicide?)*, working paper (2018), http://www.shareholderforum.com/access/Library/20170711_Ayres-Olenick.pdf (reporting that 60% of companies that have bought back their stock between 2010 and 2015 spent on average more than 100% of their net profits on dividends and share repurchases); also *see* Heather Slavkin Corzo, AFL-CIO, *Petition for Rulemaking to Revise Rule 10b-18*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (July 18, 2019), https://corpgov.law.harvard.edu/2019/07/18/petition-for-rulemaking-to-revise-rule-10b-18/#more-120241 (indicating that between 2003 and 2012 the 449 publicly listed companies included in the S&P 500 Index distributed 97% of their profits to shareholders, with 54% of profits used for repurchases).

[4] *See* FITCH RATINGS, *US Corporate Share Buybacks Resume After Pandemic-Related Hiatus* (Feb. 5, 2021), https://www.fitchratings.com/research/corporate-finance/us-corporate-share-buybacks-resume-after-pandemic-related-hiatus-05-02-2021.

[5] *See* Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 (2) AMER. ECON. REV. 323–29 (1986).

[6] For academic studies discussing the undervaluation theory see, *e.g.*, Ahmet C. Kurt, *Managing EPS and Signaling Undervaluation as a Motivation for Repurchases: The Case of Accelerated Share Repurchases*, 17 (4) REV. ACC. & FIN. 453 (2018); Uptal Bhattacharya & Stacey E. Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence*, 20 (2) REV. FIN. 725 (2016).
Business mogul Warren Buffet follows this theory and makes his firm Berkshire Hathaway repurchase its own stock whenever it trades below 1.2 times its book value, his proxy for the firm's "intrinsic value". *See* Eric Rosenbaum, *Warren Buffett Explains the Enduring Power of Stock Buybacks for Long-Term Investors*, (Sep. 1, 2018), CNBC MARKETS, https://www.cnbc.com/2018/08/31/warren-buffett-explains-the-enduring-power-of-stock-buybacks.html.

[7] Law Professor Jesse Fried and Wall Street Titan Lloyd Blankfein have each argued that buybacks can improve capital allocation, because the distributed money is reinvested in young and growing firms with better investment opportunities. *See* Jesse Fried, *Democratic Senators and the Buyback Boogeyman*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (March 13, 2019), HTTPS://CORPGOV.LAW.HARVARD.EDU/2019/03/13/DEMOCRATIC-SENATORS-AND-THE-BUYBACK-BOOGEYMAN/; *See* Liz Moyer, *Bernie Sanders and Lloyd Blankfein Get in Twitter Fight over Stock*

among them Hillary Clinton, Elizabeth Warren, Bernie Sanders, and Chuck Schumer, have argued that the cash outlay required by stock buybacks shortchanges investment in long-term productive capabilities[8] and harms employee welfare,[9] and that allowing firms to increase demand and reduce supply for their own stock through repurchases creates the potential for stock price manipulation.[10] The concerns around stock buybacks led former President Trump to announce that the COVID-19 stimulus program would prohibit firms from using the aid money for stock buybacks,[11] and have pushed the SEC to consider imposing additional requirements on its Rule 10b-18, which currently allows corporations to engage in open market buybacks with a "safe harbor" from liability for stock price manipulation.[12]

Understanding the relationship between executive compensation and stock buybacks is essential for understanding management incentives around buybacks. Previous studies by myself[13] and other scholars[14] have shown that stock buybacks can increase executive compensation by altering ratings on performance yardsticks that determine bonuses and stock awards. In this article, I argue that executives' incentives to conduct buybacks for this purpose are undesirable, as they encourage stock buybacks that destroy firm value and separate pay from performance. Because commonly used performance yardsticks, which are designed to measure the impact of ordinary business decisions on firm value, fail to properly reflect the

Buybacks, CNBC News (Feb. 5, 2019), https://www.cnbc.com/2019/02/05/blankfein-hits-back-at-senators-over-stock-buybacks-the-money-doesnt-vanish.html

[8] *See, e.g.*, Germán Gutiérrez & Thomas Philippon, *Investment-Less Growth: An Empirical Investigation*, 48 (2) BROOKINGS PAPERS ON ECONOMIC ACTIVITY, ECONOMIC STUDIES PROGRAM, 89 (2017); William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (2014); Heitor Almeida, Vyacheslav Fos & Mathias Kronlund, *The Real Effects of Share Repurchases,* 119 (1) J. FIN. ECON. 168 (2016).

[9] *See* William Lazonick, *Clinton's Proposals on Stock Buybacks Don't Go Far Enough,* HARV. BUS. REV. (Aug. 11, 2015), https://hbr.org/2015/08/clintons-proposals-on-stock-buybacks-dont-go-far-enough; William Lazonick, Mustafa Erdem Sakinç & Matt Hopkins, *Why Stock Buybacks Are Dangerous for the Economy*, HARV. BUS. REV. (Jan. 7, 2020), https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy;

On the basis of his findings, a group of Democratic senators has lately proposed bills to limit buybacks unless certain employee rights are protected. *See* Chuck Schumer & Bernie Sanders, *Schumer and Sanders: Limit Corporate Stock Buybacks,* N.Y. TIMES (Feb. 3, 2019), https://www.nytimes.com/2019/02/03/opinion/chuck-schumer-bernie-sanders.html.

[10] *See, e.g.,* Lazonick, supra note 8.

[11] *See* Leslie Josephs & Tucker Higgins, *Trump Says He is "OK" with Forbidding Buybacks as Condition of Corporate Bailouts,* CNBC (Mar. 19, 2020), https://www.cnbc.com/2020/03/19/trump-says-he-is-ok-with-forbidding-buybacks-as-condition-of-corporate-bailouts.html; Bloomberg Politics, *Trump Doesn't Want Virus Aid to Be Used for Stock Buybacks* (Mar. 20, 2020), https://www.youtube.com/watch?v=Vd6M8lhYXgc

[12] *See* Speech by Robert J. Jackson Jr., *Stock Buybacks and Corporate Cashouts* (June 11, 2018), https://www.sec.gov/news/speech/speech-jackson-061118. In addition to Commissioner Jackson, Chair Jay Clayton and Commissioner Hester Pierce have indicated support for a review of Rule 10b-18. Hazel Bradford, *New Research Warrants Revisiting SEC Stock Buyback Rules, Commissioner Says*, PENSIONS & INVESTMENTS (Mar. 6, 2019), https://www.pionline.com/article/20190306/ONLINE/190309895/new-research-warrants-revisiting-sec-stock-buyback-rules-commissioner-says; Gretchen Morgenson & Tom McGinty, *Insiders Pocket Gains on Buybacks, Vexing Regulator*, WALL ST. J. (June 10, 2018), https://www.wsj.com/articles/insiders-pocket-gains-on-buybacks-vexing-regulator-1528646400.

[13] *See* Nitzan Shilon, *Stock Buyback Ability to Enhance CEO Compensation: Theory, Evidence, and Policy Implications* (25 (1) LEWIS & CLARK L. REV. ___ (forthcoming 2021).

[14] *See, e.g.*, Yingmei Cheng, Jarrad Harford & Tianming Zhang, *Bonus-Driven Repurchases*, 50(3) J. FIN. & QUANT. ANAL. 447 (2015); Sunyoung Kim & Jeff Ng, *Executive Bonus Contract Characteristics and Share Repurchases*, 93 (1) ACC. REV. 289 (2018); Jing Yang & Stephen Young, *Stock Repurchases and Executive Compensation Contract Design: The Role of Earnings Per Share Performance Conditions*, 86 (2) ACC. REV. 703 (2011).

intertemporal, financial, and stock trading impact of stock buybacks on firm value, they invite various forms of abuse.

First, executives are incentivized to conduct stock buybacks that squander the cash earmarked for long-term investment, because they can thereby improve short-term earnings per share (EPS), which commonly determines their annual bonuses and the amount of their stock-based awards. Such buybacks do not improve short-term EPS only by reducing the number of shares—like any other stock buyback—but also by saving current accounting expenses, which lifts short-term earnings. While the short-term improvement in EPS is certain, its long-term impairment becomes apparent well after the measurement period and is uncertain. For example, a pharmaceutical company that repurchases its stock in lieu of its research to develop a new drug might, at an uncertain probability, sacrifice large profits that could be generated from selling a drug brought to market as late as a decade later, when the CEO would probably no longer be with the firm. Executives can ask themselves: why invest in working hard for the long term when you can conduct a short-term-driven buyback and be compensated for boosting EPS now?

Second, executives have an incentive to conduct stock buybacks, and especially buybacks that are financed with new debt (leveraged buybacks), that increase the firm's financial risk excessively. This happens because, in efficient markets, elevated financial risk should be compensated by increased return,[15] which, in turn, improves the executives' ratings on capital efficiency measures that decide their performance compensation, such as EPS and return on invested capital (ROIC). Regrettably, such improved ratings need not reflect improved performance or value creation. Instead, they may reflect elevated risk and reward the executive simply for assuming more risk even when it is excessive.

Third, executives have an incentive to use stock buybacks for stock price manipulation because this would improve total shareholder return (TSR), which commonly determines the amount of stock-based compensation they receive. The incentive to manipulate is high even when the price increases succeeds only temporarily, because firms commonly calculate TSR based on the last twenty days of the measurement period. Unfortunately, loopholes in the conditions set by Rule 10b-18, as well as lax disclosure rules, allow firms to secretly and materially intervene in the trading of their own stock and lift its price artificially. The success of such manipulation is evidenced by executives' high-volume stock sales following buyback announcements.

I further show that the perverse incentives to conduct value-destroying buybacks make a significant difference to the amount of CEO compensation. My empirical analysis of current executive compensation arrangements of all S&P 500 CEOs indicates that stock buybacks that destroy firm value can improve ratings on performance criteria that decide one half of their incentive compensation, which amounts to almost one third of their total pay.

My analysis is especially troubling because it shows that the executive compensation reforms undertaken to alleviate the systemic problems highlighted by the financial crisis of 2008–2009 have actually exacerbated those problems instead. Furthermore, the perverse incentives that these reforms created around stock buybacks have repercussions that extend far beyond value destruction in individual firms. In particular, the reforms have turned stock

[15] *See, e.g.*, Eugene Fama & Kenneth French, *The Capital Asset Pricing Model: Theory and Evidence*, 18 (3) J. ECON. PERS. 25 (2004).

buybacks into a means of crippling the competitive advantage of the U.S. economy, a phenomenon that Forbes has labeled "a cancer on capitalism."[16] By encouraging excessive financial risk and leverage they have contributed to the formation of a giant junk bond bubble that could pop and lead to another stock market crash and recession.[17] By encouraging executives to manipulate their firms' stock price, they have undermined the credibility and fairness of the financial system as a venue for capital formation that advances sustainable growth and social welfare.

Unfortunately, systemic corporate governance failures allow corporate executives to act on their highly undesirable buyback incentives. Buybacks in the U.S., unlike in many other countries, do not require shareholder approval, thereby weakening shareholder checks on buyback decisions. Also, CEOs enjoy considerable discretion over the timing and amount of buybacks executions within the boundaries of board-approved plans. Corporate directors have little incentive to curb executives' buyback decisions because they can sell their own stock compensation at the inflated prices that buyback announcements commonly create. In addition, severe deficiencies in disclosure rules prevent effective monitoring by shareholders. The result, I report, is that buyback activity is highly correlated with CEO pay incentives around buybacks.

Altogether, the perverse pay incentives around stock buybacks coupled with these corporate governance failures are consistent with the view that managerial power and influence have shaped executive compensation in publicly-traded U.S. companies.[18] The character of performance metrics and the way they function in practice enable executives to enrich themselves, even when buybacks impoverish long-term shareholders and destroy firm value. Ironically, the attempt to reduce agency costs and to bond the executives with their shareholders through performance metrics has transformed stock buybacks into a means of separating pay from performance, increasing agency costs, and destroying firm value.

To remedy the flaws identified in my research, I propose a regulatory reform. In particular, I propose reforming the rules that govern public firms' filings with the U.S. Securities and Exchange Commission (SEC) pursuant to Regulation S-K,[19] such that firms would be required to conspicuously disclose how they address the impact of stock buybacks on the performance targets they set for executive compensation purposes. Moreover, because Section 14A(a)(1) to the Securities Exchange Act of 1934[20] requires all public companies to present to their shareholders an advisory "Say on Pay" resolution to approve their executive compensation arrangements, revising the disclosure requirements pursuant to Regulation S-K would provide the shareholders the power to vote on such additional information. With this additional information and increased shareholder power, I expect boards and shareholders assisted by proxy advisors, executive compensation advisors, and practitioners, to identify and remedy the flaws inherent in the design of performance metrics affected by stock buybacks.

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16 *See* Steve Denning, *U.S. Senators Challenge the S.E.C. on Share Buybacks*, FORBES (July 8, 2018), https://www.forbes.com/sites/stevedenning/2018/07/08/u-s-senators-challenge-the-s-e-c-on-share-buybacks/#76f0fa438f8f.

17 *Id.*

18 *See, e.g.,* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004).

19 Regulation S-K is a prescribed regulation under the U.S. Securities Act of 1933 that lays out reporting requirements for various SEC filings used by public companies. 17 C.F.R. § 229 (2013).

20 17 CFR § 240.14a-101.

This article is developed in seven parts. In part I I describe the post-2008 rise of performance criteria in executive compensation arrangements. In part II I explain the mechanisms that enable stock buybacks to boost ratings on common performance metrics while destroying firm value. In part III I provide evidence indicating that the perverse incentives to conduct value-destroying buybacks are significant for CEO compensation. In part IV I explain why the ability of stock buybacks that destroy firm value to increase CEO pay is troubling, and in part V I describe the corporate governance failures that allow corporate executives to act on their undesirable buyback incentives. In part VI I propose reforms to improve transparency around the impact of stock buybacks on executive pay such that shareholders are equipped to respond to pertinent information in their "Say on Pay" advisory votes. In the conclusion I assess the merits of these corporate governance proposals in light of potential objections and make suggestions for future research that would build upon and extend my analysis.

I. THE RISE OF PERFORMANCE CRITERIA IN EXECUTIVE COMPENSATION ARRANGEMENTS AND THEIR INTENDED FUNCTIONING

In most large American corporations, ownership is separate from control.[21] This separation happens when managers do not own most of the shares of the corporations they run. When manager-agents own little stock in a firm and shareholder-principals are too dispersed to force managers to maximize firm value, "agency costs" are created and corporate assets may be abused to benefit managers at shareholder expense.[22] Such agency costs may be triggered by managers diverting corporate resources to themselves, taking perquisites, and exerting too little effort ("shirking"). The costs may also be triggered by managerial pursuit of non-value-maximizing objectives, such as making excessive acquisitions ("empire building"), encouraging excessive sales growth, and putting employee interests ahead of those of shareholders. When managers' time horizons differ from those of long-term shareholders,[23] they may take excessive risks and pursue short-term gains.

According to agency theory, managerial agency costs can be significantly reduced if divergences from shareholder interests are limited by establishing incentives for managers that bond their interest with the interest of the shareholders in increasing firm value.[24] In particular, managers' incentives can be significantly aligned with those of the shareholders if their pay is properly tied to their performance. The theory is that as managers take actions that increase the long-term value of the firms they run, they increase the value of their performance-contingent

[21] *See* ADOLF A. BERLE & GARDINER C. MEANS JR., THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[22] *Agency relationship* is a contract under which the principal/s engage another person/s (the agent/s) to perform some service on their behalf, which involves delegating some decision-making authority to the agent/s. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

[23] This may happen because of managers' career concerns or their ability to trade on inside information.

[24] *See* Jensen & Meckling, *supra* note 22, at 308 (explaining that "[t]he principal can limit divergences from his interest by establishing appropriate incentives for the agent…to limit the aberrant activities of the agent" (emphasis omitted)).

compensation and are therefore less likely to squander corporate wealth and more likely to work hard to increase firm value.

A. *The Rise of Performance Criteria in Executive Compensation Arrangements*

In the 1980s, shareholder activists and academics increasingly demanded that executive pay be tied more closely to company value.[25] Until then, the argument goes, CEOs of large companies were paid like bureaucrats, in the sense that executives were awarded primarily for increasing the size of their organizations. They received only small rewards for superior performance, even smaller penalties for failures, and the bonus components of the pay packages showed little variability. For example, Jensen and Murphy found that CEOs received only $3.25 for every $1000 increase in shareholder wealth.[26] In response to this criticism, in the 1990s public firms started to pay their senior executives massive amounts of stock options, such that until the mid-2000s stock-based awards made up almost two thirds of median S&P 500 CEO compensation.[27]

Firms believed that introducing stock-based compensation was so important for pay-performance alignment and maximizing firm value that they were willing to pay a high price. While total pay for CEOs in the largest U.S. firms was stable for half a century, it quintupled during the fifteen years following the introduction of stock-based awards.[28]

Firms granted these stock-based awards without conditioning their grant on meeting performance goals.[29] The idea was that stock awards would incentivize executives to work harder and better to maximize firm value, even when they are not performance-conditioned, because maximizing firm value would increase the stock price and would thus increase the value of the executive's stock and stock option compensation. This belief was strongly tied to the growing popularity of the Efficient Capital Market Hypothesis, which holds that public security prices fully reflect all information about a security, and hence, that only desirable business decisions are expected to increase the value of the stock that is awarded as compensation.[30]

However, in the aftermath of the 2008 financial crisis, widespread criticism was sparked over granting incentive compensation for business failures. For example, then-President Barack Obama branded the conduct of failing Wall Street bankers "shameful" for giving

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[25] *See* Michael Jensen & Kevin Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, 68 (3) HARV. BUS. REV. 138 (1990); Michael Jensen & Kevin Murphy, *Performance Pay and Top Management Incentives*, 88 (2) J. POL. ECON. 225 (1990) (arguing that CEOs of large companies were paid like bureaucrats in the sense that they were primarily paid for increasing the size of their organizations, received small rewards for superior performance, even smaller penalties for failures, and that the bonus components of the pay packages showed very little variability).

[26] *Id.*

[27] In 1985 the median S&P 500 CEO had no equity in his pay package. *See* Kevin Murphy, *Executive Compensation: Where We Are, and How We Got There, in* HANDBOOK OF THE ECONOMICS OF FINANCE (G. Constantinides, M. Harris and R. Stulz, eds. Amsterdam: Elsevier/North-Holland 2012). In 2000–2005, in contrast, equity pay made up 60% of total pay. *See* Carola Frydman & Dirk Jenter, *CEO Compensation*, 2 ANN. REV. FIN. ECON. 80 (2010).

[28] *See* Murphy, *supra* note 27.

[29] *Id.*

[30] *See* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25(2) J. FIN. 383 (1970).

themselves nearly $20 billion in bonuses as the government was spending billions to bail them out.[31]

Relatedly, institutional investors became less sympathetic to the argument that plans that pay stock awards without requiring the executive to meet certain performance hurdles are inherently performance-based.[32] Their view that the incentive to maximize the stock price is insufficient to encourage corporate executives to take value-maximizing business decisions has received support from prominent financial economists, who have attacked the Efficient Capital Market Hypothesis on the ground that pricing irregularities and predictable patterns in stock returns can appear over time and even persist.[33]

Coinciding with the passage of Dodd-Frank and the resultant implementation of mandatory votes on executive compensation (known as "Say on Pay"), institutional investors gained considerable power to impact companies' pay practices. Aided by advisory firms such as ISS and Glass Lewis, they have become more aggressive in their attempts to improve the alignment of CEO compensation with company performance.

Firms quickly responded to this pressure and added performance conditions to their executives' incentive pay plans. Performance-conditioned awards have become the most common vehicle by which long-term incentive compensation is delivered.[34] Specifically, they currently amount to an unprecedented 58 percent of the $7.7 million that S&P 500 CEOs receive on average in long-term incentives.[35] The heightened scrutiny from proxy advisory firms and institutional investors increased pressure on companies to further emphasize performance-conditioned pay in their executives' annual bonus plans. The pressure was aided by a 2006 SEC rule that considered annual bonuses as "non-equity incentive compensation" only if they were based on pre-established and communicated performance targets.[36] Consequently, firms increased their focus on the rigor of metric selection, weighting, and goal-setting in these plans. A record high number of firms (83 percent) currently disclose use of a formulaic annual bonus plan design with pre-defined metrics and metric weightings.[37] Such metrics emphasize financial and accounting performance criteria.

B. The Way Performance Criteria Should Function

Performance measurements should reflect the impact of business decisions on firm value. *If and only if* a certain business decision is expected to increase the intrinsic value of the firm,

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[31] *See* Sheryl Gay Stolberg & Stephen Lebaton, *Obama Calls Wall Street Bonuses 'Shameful',* N.Y. TIMES (Jan. 29, 2009), https://www.nytimes.com/2009/01/30/business/30obama.html.

[32] *Id.*

[33] See, e.g., Burton G. Malkiel, The Efficient Market Hypothesis and Its Critics, 17(1) J. ECON. PERS. (2003);

Stanford Grossman and Joseph Stiglitz, On the Impossibility of Informationally Efficient Markets, 70 AM. ECON. REV. 393 (1980); Eugene Fama & Kenneth French, *The Cross-Section of Expected Stock Returns*, 47 (2) J. FIN. 427(1992).

[34] While in 2011 only 31% of equity grants among S&P 500 companies were performance-conditioned, seven years later the proportion of such grants had almost doubled to 58%. *See* EQUILAR, INC., 2016 CEO PAY TRENDS (March 2017); *see* EQUILAR, INC., 2018 CEO PAY TRENDS (July 2019) (both on file with author).

[35] *See* 2018 EQUILAR, INC., *supra* note 34.

[36] *See* Kevin Murphy, *Executive Compensation, in* HANDBOOK OF LABOR ECONOMICS, vol. 3B, Orley Ashenfelter and David Card, eds. (Amsterdam: North Holland, 1999), at 221.

[37] *See* FW COOK, 2019 ANNUAL INCENTIVE PLAN REPORT (October 2019), at 9 https://www.fwcook.com/content/documents/publications/10-17-19_FWC_2019_Incentive_Plan.pdf

the measurement of performance should improve, and executive compensation should increase. In principle, if the Efficient Capital Markets Hypothesis worked perfectly in the real world the stock price could be a perfect performance criterion, as it would capture accurately and instantaneously the impact of business decisions on firm value. But if capital markets are not in fact efficient, the performance metrics that firms select and the weighting they assign to each should measure the impact of business decisions on firm value better than the stock price. Certain business decisions can positively impact some aspects of performance, such as capital efficiency, while negatively affecting other aspects, such as those related to operational functioning. The selection and weighting of performance metrics should calibrate the relative importance of each aspect of performance on firm value.

Three conditions are especially important for ensuring that performance criteria properly reflect the impact of business decisions on firm value. First, such criteria and the awards that are based on them must properly balance the influence of business judgment on company value in both the short and the long term. Specifically, when a certain business decision creates an immediate positive impact on performance but is expected to reverse later on, the system of performance awards should ensure that the executive internalizes the long-term effect of her decisions. Prominent academics have recognized the failure of the current system of performance metrics and awards to impose such internalization, and they have proposed certain reforms. Baghat and Romano have suggested that executives should not be allowed to sell the stock and stock options that they receive as compensation for a period of at least two to four years after the executive's resignation or last day in office.[38] Bebchuk and Fried have advocated for grant-based and aggregate limitations on the unwinding of stock awards.[39]

Second, performance criteria should account for risk. Generating cash flows with little risk is more valuable for shareholders than generating the same amount of cash with high risk. Finance theory recognizes this difference and allocates higher discount rates and lower value to cash flows that involve higher risk.[40]

Yet, capital efficiency measurements, such as earnings per share (EPS), return on equity (ROE), and return on invested capital (ROIC), that are commonly used as performance metrics in executive compensation arrangements, are not risk adjusted. Furthermore, performance measurements generally do not account for leverage, even though extra leverage results in additional financial risk.

Third, properly constructed performance measurements should be immune to manipulation and gaming. For example, firms commonly follow the generally accepted accounting principles (GAAP) applicable to EPS calculations, which aim to prevent companies from manipulating the timing of business decisions to improve EPS inappropriately. Such rules discourage opportunism by requiring that the calculation of EPS be based on the weighted average of the number of outstanding shares over the measurement period.[41] Absent this rule firms could time

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[38] *See* Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. REG. 359 (2009).
[39] *See* Lucian Bebchuk & Jesse Fried, *Paying for Long-Term Performance*, 158 U. PENN. L. REV. 1915, 1958 (2010).
[40] For example, the Capital Asset Pricing Model holds that higher exposure to systemic risk must result in higher discount rates and lower pricing. See, *e.g.*, Fama & French, *supra* note 15.
[41] *See* ERNST & YOUNG, *Earnings Per Share* (August 2019), https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_bb1971_earningspershare_14august2019-v3/$file/financialreportingdevelopments_bb1971_earningspershare_14august2019-v3.pdf

the calculation of the number of shares for EPS purposes for before they increase the number of shares or after they reduce it.

Unfortunately, there are no available GAAP or other anti-gaming rules applicable to many other performance measurements that firms commonly use to gauge executive performance. Their absence enables corporate executives to take advantage of such loopholes and initiate business decisions that manipulate ratings on performance measures that decide their incentive compensation.

II. STOCK BUYBACKS CAN GREATLY IMPROVE RATINGS ON COMMON PERFORMANCE METRICS WHILE DESTROYING FIRM VALUE

Even if stock buybacks destroy firm value, they can improve the ratings on common performance metrics that decide executive compensation. In particular, this will happen when a buyback sacrifices long-term for short term value, imposes excessive financial risk, or triggers stock price manipulation. The ability of such value-destroying buybacks to increase executive compensation creates an incentive for corporate executives to harm the value of the firms they run.

A. Short-Term-Driven Buybacks Can Greatly Improve Ratings on Important Performance Metrics

Short-term-driven buybacks mean stock buybacks that pursue short-term gains at the expense of long-term value creation. For example, when the buyback distributes resources that would otherwise sponsor value-increasing long-term projects. I argue that this can improve ratings on performance metrics in the short term at the expense of long-term value creation. A well-constructed incentive pay system, one that properly balances the influence of business judgment on company value in both the short and the long term, should not increase executive compensation when a firm conducts short-term-driven buybacks.

1. Short-term-driven buybacks can improve short-term earnings per share

Short-term-driven buybacks enhance short-term EPS. This important performance criterion is defined as total earnings of the firm for the measurement period divided by its number of shares outstanding.[42] Short-term-driven buybacks can improve short-term EPS in two ways.[43] First, they lift current earnings by saving the immediate cost required to build new plants, invest in human capital, or conduct research and development. Second, any buyback immediately reduces the number of shares.

Take, for example, a company with earnings of $100, after accounting for a $10 expense for long-term value-creating research and development, and 100 outstanding shares. The resulting EPS is $1. If that company conducted a $10 short-term-driven buyback instead of carrying out value-creating R&D it would improve EPS as follows: (i) earnings, the EPS

[42] The number of shares outstanding represents the amount of stock on the open market, including shares held by institutional investors and restricted shares held by insiders and company officers.
[43] For studies that recognized the ability of buybacks to improve EPS, *see, e.g.*, Almeida et al., *supra* note 7; Daniel Bens, Venky Nagar & Franco Wong, *Real Investment Implications of Employee Stock Option Exercises,* 40(2) J. ACC. RES. 359–93 (2002).

numerator, would rise from \$100 to \$110;[44] and (ii) the number of shares, the EPS denominator, would be reduced from 100 to 95. The cost of buying back the stock would not affect earnings because, unlike the research and development expense, it is recorded in the balance sheet and not in the income statement. Overall, the short-term-driven buyback would improve EPS considerably, from \$1 to \$1.158.

Bruce Broussard, CEO of Humana Inc., benefited from the functioning of short-term-driven buybacks to improve EPS in the short term. The company's \$730 million share repurchase reduced its number of shares outstanding and thereby added around three cents to its annual EPS, which allowed Mr. Broussard to surpass his \$7.50 EPS target by a single cent, despite Humana's worse-than-expected 21 percent drop in net income.[45]

A recent Goldman Sachs study indicates that Mr. Broussard is not alone. It reports that firms commonly repurchase their own shares to improve EPS. According to the investment bank's calculations, over the past fifteen years, EPS growth outpaced actual earnings growth by 2.6 percentage points due to stock buybacks.[46]

Other studies reveal that firms that use EPS as a performance metric for executive compensation purposes conduct more buybacks. The odds of a repurchase where executive compensation depends on EPS performance are significantly higher than the level observed for firms where rewards are independent of EPS.[47] Moreover, companies are especially likely to repurchase shares and spend more on repurchases when absent the repurchase their CEOs would just miss their bonus threshold EPS level[48] or consensus EPS forecasts.[49]

2. Short-term-driven buybacks can improve short-term ratings on other performance criteria

Short-term-driven buybacks are likely to improve short-term ROE, a product of dividing net income by shareholder equity. This should happen because (i) as explained earlier, in the short term, short-term-driven buybacks are not expected to reduce earnings or net income; and (ii) any buyback immediately reduces the firm's number of shares, and therefore, its equity, calculated as the number of shares multiplied by their price.

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[44] The research and development cost should be recorded in the income statement, as long as the company is unable to prove that the investment will certainly result in a future revenue. Therefore, it reduces earnings,

[45] *See* Karen Bretell, David Gaffen & David Rohde, *Stock Buybacks Enrich the Bosses Even When Business Sags*, Reuters Investigates (Dec. 10, 2015), *available at* https://www.reuters.com/investigates/special-report/usa-buybacks-pay/ (indicating that, based on the share count before the buybacks, EPS would have been only \$1.81).

[46] *See* Theron Mohamed, *Goldman Sachs Sees Stock Buybacks Diving 15% this Year—and Warns Equities Could Suffer if the Trend Gains Steam*, BUS. INS. US (Dec. 16, 2019), https://www.businessinsider.sg/goldman-sachs-warns-drop-stock-buybacks-threatens-equity-prices-2019-12/.

[47] *See* Yang & Young, *supra* note 13 (documenting that the odds of a repurchase for firms where executive compensation depends on EPS performance are almost twice the level observed for firms where rewards are independent of EPS); Cheng et al. *supra* note 13 (reporting that when a CEO's bonus is directly tied to EPS, his company is more likely to conduct a buyback); Ira Kay, Blaine Martin & Chris Brindisi, *Myths and Realities: Assessing the True Relationship Between Executive Pay, Share Buybacks, and Managerial Short-Termism*, PAY GOVERNANCE (Jan. 13, 2016), https://www.paygovernance.com/viewpoints/myths-and-realities-assessing-the-true-relationship-between-executive-pay-share-buybacks-and-managerial-short-termism

[48] *See* Kim & Ng, *supra* note 13; Cheng et al. *supra* note 13; Almeida et al., *supra* note 6, Fos & Kronlund, *supra* note 7.

[49] *See* Kurt, *supra* note 6.

In addition to improving ROE, when sponsored by internal resources short-term-driven buybacks are expected to enhance short-term ratings on other per share performance criteria, such as return on assets (ROA), calculated by dividing net income by total assets, as well as return on invested capital (ROIC), defined as the ratio between the company's net operating profit after tax and the firm's invested capital (total debt and equity). This should happen because (i) short-term-driven buybacks do not change such metrics numerators because they do not harm short-term earnings, net income or profits; and (ii) when they are sponsored, at least in part, by internal resources, short-term-driven buybacks are expected to lower the ROA/ROIC denominators: assets and invested capital.

As explained in Section C below, short-term-driven buybacks also assist in manipulating the stock price, at least in the short term. This boost, in turn, should improve total shareholder return (TSR), calculated as the percentage of stock price appreciation (plus dividend yield), even if the intrinsic value of the firm does not improve.

3. Short-term-driven buybacks harm long-term performance, but executives need not fully internalize the cost

In the long term, however, short-term-driven buybacks can harm EPS, other per share performance criteria, and TSR because they force the company to give up the additional value that forgone long-term investment would have generated. Because short-term-driven buybacks sacrifice long-term value, the foregone long-term share value, earnings, equity value, assets, and invested capital can result in long-term harm to the corresponding criteria that determine executive incentive pay.

Unfortunately, even though short-term-driven buybacks reduce long-term ratings on performance metrics and even when they reduce the present value of the sum of executive compensation in the short and long term combined, the current system often provides executives with incentives to conduct short-term-driven buybacks.

One reason is that senior executives often do not stay with the firm through the long term. Because of increased competition and the heightened scrutiny that CEOs face today, the average tenure of a departing S&P 500 CEO has shrunk to only 7.8 years, down from 10.8 years in 2015.[50] The tenure of CEOs at large-cap companies has recently dropped to only five years.[51] With such short tenure, many CEOs do not suffer the adverse long-term consequences of short-term-driven buybacks on their pay.

Managers who know their imminent departure date are especially motivated to conduct short-term-driven buybacks. The short-term performance improvement will not only increase their immediate compensation, but will also improve their reputation, status, and opportunities on the job market.

When firms conduct short-term-driven buybacks consistently, they can also significantly postpone the emergence of their negative long-term impact on performance measures and pay. A recent Goldman Sachs study reports that over the past fifteen years, stock buybacks pushed

[50] *See* Press Release, The Conference Board, Inc., *CEO Succession Practices*, (Dec. 10, 2020), https://conference-board.org/press/CEO-Succession-Practices-2020-Report.

[51] *See* Press Release, Equilar Inc., CEO Tenure Drops to Just Five Years (Jan. 19, 2018), https://www.equilar.com/blogs/351-ceo-tenure-drops-to-five-years.html

EPS growth to outpace actual earnings growth by an average of 2.6 percent, greatly extending the short-term impact of buybacks on EPS.[52]

Under these conditions executives can ask themselves why they should invest in working hard for the long term when they can conduct a short-term-driven buyback and be compensated for boosting EPS now. Almeida, Fos and Kronlund provide empirical evidence that managers are indeed willing to trade off investment and employment for stock repurchases that improve short-term EPS.[53] Gutiérrez and Philippon further report that despite high levels of profitability and Tobin's Q, private fixed investment in the United States has been lower than expected since buybacks started to skyrocket in the early 2000s.[54]

B. Buybacks that Impose Excessive Financial Risk Can Greatly Improve Ratings On Important Performance Metrics

Stock buybacks increase financial leverage, defined as the ratio between the firm's debt and equity. When the buyback is financed by internal resources the ratio between debt and equity increases because the sum used to finance the buyback reduces the firm's equity while not affecting the value of its debt. When the buyback is leveraged, or financed with debt, the ratio between debt and equity increases even more forcefully because, in addition to the reduction in equity, the raised money increases the amount of debt.

Increased financial leverage elevates the financial risk attached to the stock and magnifies the potential profit or loss for the stockholders. This happens because the elevated ratio of debt to equity reduces the ratio of equity to firm value; and hence each given change in profitability is shared by fewer residual claimants—the shareholders. For example, if a $1 change in profitability before the buyback was shared by 100 shareholders and therefore changed their EPS by 1 cent, after the buyback the same change in profitability would be shared by fewer shareholders and hence change their EPS by more than 1 cent.

When the riskiness attached to a stock increases, the expected return on the stock must rise as well to compensate for the extra risk. This relationship between risk and return is well established in the financial literature.[55]

The extra expected stock return following a stock buyback stands to improve important performance metrics that decide executive compensation. The extra stock return is expected to directly improve TSR. It should also elevate EPS and other capital efficiency measures to reflect the expected increase in return on investment. The improvement should be greater if the buyback is more leveraged.

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[52] *See* Mohamed, *supra* note 46.

[53] *See* Almeida et al., *supra* note 7.

[54] *See* Gutiérrez & Philippon, *supra* note 7. Whether stock buybacks (but not the pay incentives around buybacks) reduce investment has been the subject of substantial analysis and debate. For studies that deny the adverse impact of buybacks on investment please *see, e.g.*, Jesse Fried & Charles Wang, *Short-Termism and Capital Flows*, 8 (1) REV. COR. FIN. STUD. 2017 (2019).

[55] *See, e.g.,* Fama & French, *supra* note 15.

The problem, however, is that the expected improvement in performance metrics following stock buybacks, and especially leveraged stock buybacks, does not reflect value creation. Instead, it results from the manager's decision to elevate the firm's financial risk.

The extra compensation that executives are expected to receive for elevating financial risk gives them an incentive to conduct leveraged stock buybacks even when the additional risk is excessive. When it is excessive and firm value decreases, the ratings on performance metrics that decide executive pay should deteriorate too. Yet, at least for some value-destroying buybacks, the improvement in the ratings on financial metrics that the extra risk triggers outweigh the impairment of such ratings resulting from the value destruction.

Critics might argue that corporate executives are not motivated to conduct leveraged buybacks that harm the shareholders because the improved ratings on performance metrics make shareholders better off too. Likewise, when the excessive risk materializes and company business sags, the additional debt service obligation imposed by the extra leverage will not only make shareholders worse off, but will also impair earnings, EPS, TSR, and performance compensation.

Nonetheless, there are good reasons to think that corporate executives are motivated to conduct leveraged buybacks excessively. For one thing, CEOs are commonly overconfident in the sense that they tend to think that they are more capable than they really are.[56] This bias makes them underestimate the increased likelihood of financial distress imposed by the extra leverage that leveraged buybacks impose. Consistent with this concern, studies have found that overconfident US CEOs tend to lever firms up excessively.[57]

Also, investment bankers can be expected to join forces with corporate executives to conduct leveraged buybacks, even when they destroy firm value. Bankers have twin incentives to market leveraged buybacks to their clients even when they impose excessive leverage. First, they profit from the interest they charge for providing new debt that finances these buybacks. Second, they charge additional fees for acting as intermediaries between the firm and its shareholders in executing the buyback. The expected improvement in a firm's perceived performance is a strong selling point that bankers can use to market these buybacks. The executives, who stand to pocket extra compensation from such perceived improvement, have an incentive to turn a blind eye to the fact that the enhancement in capital efficiency measures merely reflects excess risk and can destroy firm value overall.

My argument that executive pay arrangements encourage corporate executives to conduct leveraged buybacks excessively adds to the existing literature on the proliferation of leveraged buybacks. For example, Mark Roe argues that low interest rates explain, in part, the surge in leveraged buyback activity.[58] Indeed, the low interest rates that central banks have forced in recent years have made the direct cost of leveraged buybacks relatively low, and hence, more attractive. Roe's explanation is plausible, but executives have an additional interest to conduct

[56] *See* John Graham, Campbell Harvey & Manju Puri, *Managerial Attitudes and Corporate Actions*, 109 (1) J. FIN. ECON. 103 (2013).

[57] *See* Dirk Hackbarth, *Managerial Traits and Capital Structure Decisions*, 43 (4) J. FIN. & QUANT. ANAL. 843 (2008).

[58] *See* Mark J. Roe, *Stock Market Short-Termism's Impact,* 167 U. PA. L. REV. 71 (2018).

leveraged buybacks that has been ignored: such buybacks increase executive compensation even when they destroy firm value.

C. Buybacks that Manipulate the Stock Price Can Greatly Improve Ratings on TSR, an Important Performance Metric

1. Absent proper regulation, buybacks can lift the stock price

Until 1982 stock buybacks in the U.S. were illegal, because they could be used to manipulate the stock price.[59] Absent proper regulation, buybacks can inflate the stock price without improving the intrinsic value of the firm by interfering with the free and fair operation of the stock market. In order to repurchase stock on the stock exchange, the firm must infuse extra demand for its own stock.[60] This additional demand can even accelerate when: (i) stock traders are misled into thinking that the excess demand for the firm's stock is provided by disinterested investors and, therefore, that it reflects unbiased estimations that real value has been created; (ii) the buyback improves the odds that financial analysts will recommend buying the company stock because, as discussed earlier, short-term-driven buybacks unduly assist firms to meet the EPS forecasts that financial analysts set. Indeed, a large body of finance and accounting literature reports that firms use buybacks opportunistically to meet or beat EPS forecasts set by analysts,[61] and that they tend to conduct more buybacks when they would have missed the consensus EPS forecast had they not implemented the repurchase;[62] (iii) The literature also relatedly reports that the undue EPS improvement should boost demand by market participants who rely on price-to-earnings per share (P/E) ratios as a proxy for stock valuations.[63]

In addition to increasing stock demand unduly, a buyback reduces its supply artificially because the company takes the repurchased stock off the market. When the buyback increases demand and depresses supply regardless of its merits, the stock price appreciates even when the buyback does not improve the intrinsic value of the firm.

Furthermore, when the repurchase shortchanges long-term value, it can improve the company stock price if the market suffers from myopia. That is, it undervalues long-term performance relative to the short term. The increasing focus of American financial markets on seeking short-term gains rather than long-term investments has led former presidential candidate Hillary Clinton to criticize this phenomenon and dub it as "quarterly capitalism."[64] Short-term-driven stock markets can be expected to reward firms that conduct short-term-

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[59] In 1982 SEC Rule 10b-18 was promulgated, providing firms a safe harbor protection from market manipulation charges.

[60] *See* M. A. Gumport, *The Next, Great, Corporate Scandal: Potential Liability of Corporations Engaged in Open Market, 10b-18 Buybacks; A Minority View; Case Histories; Summary of Published Studies; Direction of Future Research* (working paper, 2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=927111

[61] *See, e.g.*, Paul Hribar, Nicole Jenkins & Bruce Johnson, *Stock Repurchases as an Earnings Management Device*, 41 (1) J. ACC. & ECON. 3 (2006); Kurt, *supra* note 6.

[62] Hribar et al., *supra* note 61.

[63] *See* McKinsey & Co., *How Share Repurchases Boost Earnings without Improving Returns* (Apr. 2016), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-share-repurchases-boost-earnings-without-improving-returns.

[64] *See* Myles Udland, *HILLARY: Corporate America Is Obsessed with 'Quarterly Capitalism'—Here's How I'd Change That,* BUS. INS. (Apr. 2, 2016), https://www.businessinsider.com/hillary-clinton-quarterly-capitalism-2016-4.

driven buybacks that improve performance metrics in the short-term and create a façade of success.

The ability of buybacks to inflate the stock price artificially should not be confused with their ability to lift the stock price properly. For example, when firms sponsor their buybacks with unprofitable assets or with free cash flows that otherwise could be used to increase managerial agency costs[65] they increase firm value and should appreciate the stock price properly. Likewise, when the stock is undervalued and the company repurchases stock in order to bridge the asymmetric information and credibly signal its private information about the higher intrinsic value of the stock, it should properly lift the share price.[66] When the firm times the market well and repurchases undervalued stock it diverts value from the selling to the remaining shareholders.[67] This, in turn, should properly improve the stock price. My critique does not attack such good reasons for stock buybacks.

2. Current regulation is insufficient to prevent buybacks from manipulating the stock price

SEC "safe harbor" Rule 10b-18, which legalized stock buybacks, sets some limitations on how firms may repurchase their own stock.[68] For example, the safe harbor conditions its protection against stock price manipulation charges to daily repurchases not exceeding 25 percent of the previous four weeks' average daily trading volume.[69] This measure should have limited the interference of company-infused demand for its own stock from materially affecting the stock price.

This limitation is insufficient, however, to prevent a material change in the equilibrium price of the stock. Goldman Sachs reports that since 2011 buybacks have been the single biggest source of U.S. equity demand. This practice has materially shifted the supply-demand curve and created higher stock prices.[70]

Lax disclosure rules related to stock buyback activity allow firms to conduct buybacks undetected and weaken market forces that could have curbed stock price manipulation. Whereas insiders are required to report their stock transactions within two business days, firms may go for an entire quarter without disclosing their buyback activity, and even then they are required to report only monthly aggregate amounts.[71] This lapse in disclosure is uncommon in

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[65] See, e.g., Jensen, *supra* note 5.

[66] *See, e.g.*, Kurt, *supra* note 6; Francis H. Buckley, *When the Medium Is the Message: Corporate Buybacks as Signals*, 65 Ind. L.J. 493, 516 (1990); Robert Comment & Gregg A. Jarrell, *The Relative Signaling Power of Dutch-Auction and Fixed-Price Self-Tender Offers and Open-Market Share Repurchases*, 46 J. FIN. 1243, 1245 (1991); William J. McNally, *Open Market Stock Repurchase Signaling*, 28 FIN. MGMT. 55, 57–58 (1999); Ranjan D'Mello & Pervin K. Shroff, *Equity Undervaluation and Decisions Related to Repurchase Tender Offers: An Empirical Investigation*, 55(5) J. OF FIN. 2399–2424 (2000); Bhattacharya & Jacobsen, *supra* note 6.

[67] *See* Fried, *supra* note 7. Yet, Lazonick doubt that firms time the market well and reports that major companies conduct buybacks in boom periods when stock prices are high. See Lazonick et al., *supra* note 9.

[68] What constitutes market manipulation legally is complex. *See generally* Merritt B. Fox, Lawrence R. Glosten & Gabriel Rauterberg, *Stock Market Manipulation and Its Regulation,* 35 (1) YALE J. REG. 67 (2018).

[69] *See* 17 CFR § 240.10b-18.

[70] *See* Mohamed, *supra* note 46.

[71] *See* Andrew Ross Sorkin, *Stock Buybacks Draw Scrutiny from Politicians*, N.Y. TIMES (Aug. 10, 2015), https://www.nytimes.com/2015/08/11/business/stock-buybacks-draw-scrutiny-from-politicians.html;Testimony of Professor Jesse Fried before U.S. House of Representatives (Oct. 17, 2019), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-friedj-20191017.pdf, at 8.

other developed markets.[72] It prevents outside investors from distinguishing buyback trades from trades made by disinterested parties, creating the misapprehension that the stock is in high demand. This, in turn, prevents sophisticated traders from knowing when they should place sale or short sale orders to counter the artificial demand provided by the buyback. They may accordingly be misled into thinking that the stock is in high demand and place superfluous demand orders that exacerbate the price manipulation.

Empirical studies confirm that stock repurchases can lift stock price even when they do not actually increase a firm's earnings or otherwise do anything to prove that it is becoming financially stronger. Researchers have found that buybacks provide price support for stocks that remains overvalued despite recent low returns.[73] They have also found that stock prices tend to decline when repurchasing firms enter mandatory no-repurchase periods.[74] Moreover, Goldman Sachs reports that when firms conduct stock buybacks consistently they can manipulate the stock price for a prolonged period. The investment bank reports that buybacks have been a key feature of this last decade's bull market, the longest on record.[75]

As elaborated below in Part III.E., the stock sale activity of corporate insiders indicates that they believe that buybacks bump the stock price, at least in the short term. They disproportionately time their equity sales to share repurchases, seeking personal gain from the stock price bump that they expect buybacks to create.[76]

3. Stock price manipulation improves TSR, an important performance criterion

When stock buybacks inflate the stock price, they lift TSR, calculated as the percentage of stock price appreciation (plus dividend yield).[77] Even a temporary manipulation of the stock price can significantly alter TSR because, unlike with EPS, accounting rules do not define how firms should calculate TSR. Instead, firms commonly choose to calculate TSR by comparing the stock price at the beginning of the measurement period to the stock price average over the last twenty days of that period.[78] When a firm conducts a buyback that changes the stock price during the last days of the measurement period, even if only temporarily, it effectively

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[72] In particular, the United Kingdom, Japan, and Hong Kong require companies to disclose stock buybacks within one day. *See* Lazonick, *supra* note 8 (citing then-presidential front-runner Hillary Clinton's speeches of July 13 and July 24, 2015, in which she offered what some think is her first salvo in the regulation of buybacks: "Other advanced economies—like the United Kingdom and Hong Kong—require companies to disclose stock buybacks within one day. But here in the United States, you can go an entire quarter without disclosing. So let's change that."); also *see* Corzo, AFL-CIO, *supra* note 3.

[73] *See* Harrison Liu & Edward P. Swanson, *Is Price Support for Overvalued Equity a Motive for Increasing Share Repurchases?* 38 J. COR. FIN. 77 (2016).

[74] *See* Aneel Keswani, Jing Yang & Steven Young, *Do Share Buybacks Provide Price Support? Evidence from Mandatory Non-Trading Periods,* 34 (5) J. BUS. FIN. & ACC. 840 (2007).

[75] *See* Mohamed, *supra* note 46.

[76] *See* David Moore, *Managerial Self-Interest and Strategic Repurchases: Evidence from Equity Vesting Schedules* (June 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3014462.

[77] Many firms use a *relative* total shareholder return measure, which calculates total shareholder return compared with the company's peer group.

[78] *See* RADFORD CONSULTING, A HOW-TO GUIDE ON CALCULATING TOTAL SHAREHOLDER RETURN, https://peertracker.aon.com/PeerTrackerLegacy/V2/files/whitepaper_tsr_howto_guide.pdf, at 2 (reporting that firms in their database, which includes more than 420 companies, use a median averaging period of 20 days, and a mean averaging period of 39 days).

transforms TSR. This distortion can be significant as TSR is the single most important measurement that decides the amount of stock that executives receive as compensation.[79]

III. BUYBACKS THAT IMPROVE RATINGS ON PERFORMANCE METRICS CAN GREATLY INCREASE CEO PAY

Firms tie their executives' bonuses and equity awards to performance marks such as EPS and TSR. By means of their ability to improve these ratings, value-destroying buybacks can greatly increase executive compensation. For example, despite a decline in both revenues and net income, a $1.1 billion in share repurchases sponsored in part by a drop in research and development spending helped Xerox CEO, Ursula Burns, exactly hit her annual bonus EPS target in 2014. Meeting her target secured Ms. Burns a bonus of $1.98 million.[80] In addition, because EPS decides a major part of her long-term incentive awards, the buyback enhancement of EPS rating is likely to have boosted the equity compensation of the printer and copier maker's CEO even more.[81]

In this section I present an empirical analysis confirming that improved ratings resulting from value-destroying buybacks on performance criteria such as EPS and TSR significantly affect the value/amount of CEO pay. I show that even small improvements in ratings commonly lift performance awards significantly.

To assess the potential increase in CEO pay that value-destroying buybacks can trigger, I surveyed all compensation arrangements of CEOs included in the S&P 500 Index.[82] From ISS Incentive Lab I obtained data regarding CEO performance measures, including weighting and target value. Using Compustat, I collected information on stock buyback activity.[83] When necessary, I pulled missing data from companies' proxy statements about the weight given to each performance metric.[84] The gist of my findings is (1) that ratings that buybacks can inflect decide a significant fraction of CEO bonuses,(2) that ratings that buybacks can inflect decide an even larger fraction of CEO long-term incentive plan (LTIP) awards, and (3) that overall, such ratings decide a significant fraction and amount of total CEO pay.

A. Buybacks Can Inflect Ratings That Decide a Significant Fraction of CEO Bonuses

On average, the target value of awards decided by Buyback-Inflected Ratings accounts for more than $350,000, or almost 20 percent of S&P 500 CEO annual bonuses (Table III). Ratings on EPS have the biggest effect on CEO bonuses of all the types of rating changes, amounting to 40 percent of the total bonus on average. This happens because EPS is by far the most

[79] See discussion in the next section.

[80] *See* Bretell et al., *supra* note 45.

[81] *I.d.*

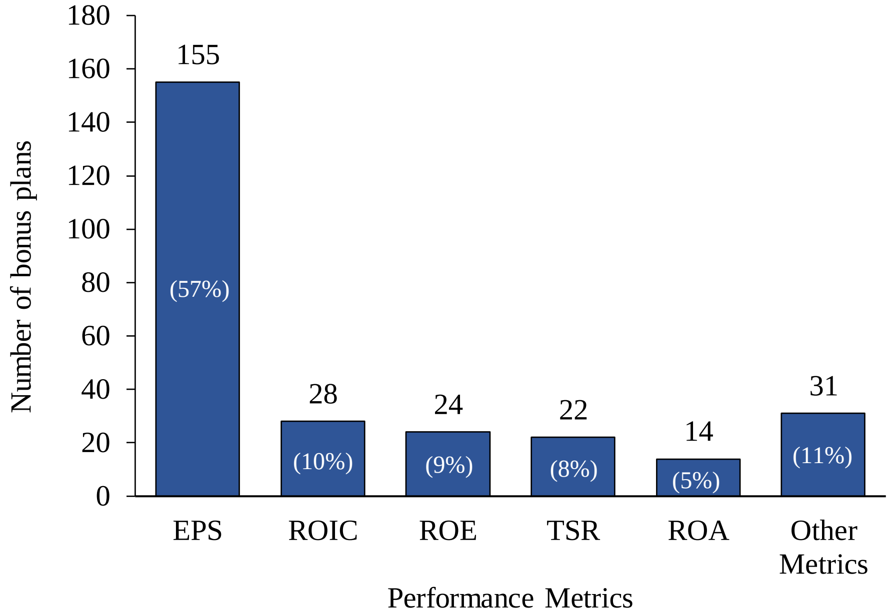
[82] The empirical information included in this section is largely based on a separate study I conducted, *Executive Pay Sensitivity to Stock Buybacks: Evidence, Implications, and Proposed Remedy*, 25 LEWIS & CLARK L. REV. (forthcoming 2021).

[83] Following Kahle et al., I use the variable *purchases of common and preferred stock* (prstkc) to measure stock repurchase. *See* Kathleen Kahle, Edward Dyl & Monica Banyi, *Measuring Share Repurchases* (working paper), https://ssrn.com/abstract=726284 or http://dx.doi.org/10.2139/ssrn.726284.

[84] When neither ISS Incentive Lab data nor companies' proxy statements indicate the portion that each criterion determines in a specific grant, I assumed equal weighting for all metrics. Further, because ISS Incentive Lab does not distinguish among threshold, modifier, and baseline criteria, I treated all of them as if they were baseline measures, with equal weighting for each type of measure.

commonly used criterion for deciding bonus awards more than all other criteria that buybacks can inflect combined (Figure I), and because EPS decides the highest fraction of the bonus when the bonus is decided by multiple criteria (Table I).

FIGURE I: PREVALENCE OF PERFORMANCE CRITERIA IN BONUS PLANS THAT BUYBACKS CAN INFLECT



Source: ISS Incentive Lab.
Sample: Based on 274 bonus plans awarded to 211 CEOs of firms included in the S&P 500. Data as of Q4 2018.

TABLE I: VALUE AND WEIGHT OF PERFORMANCE CRITERIA IN BONUS PLANS THAT BUYBACKS CAN INFLECT

Performance Criterion	***Average Portion of Bonus That the Criterion Decides***	***Average $ Value of Bonus That the Criterion Decides***
EPS	39%	742,365
ROE	34%	647,190
ROA	27%	506,333
TSR	25%	475,876
ROIC	23%	437,803

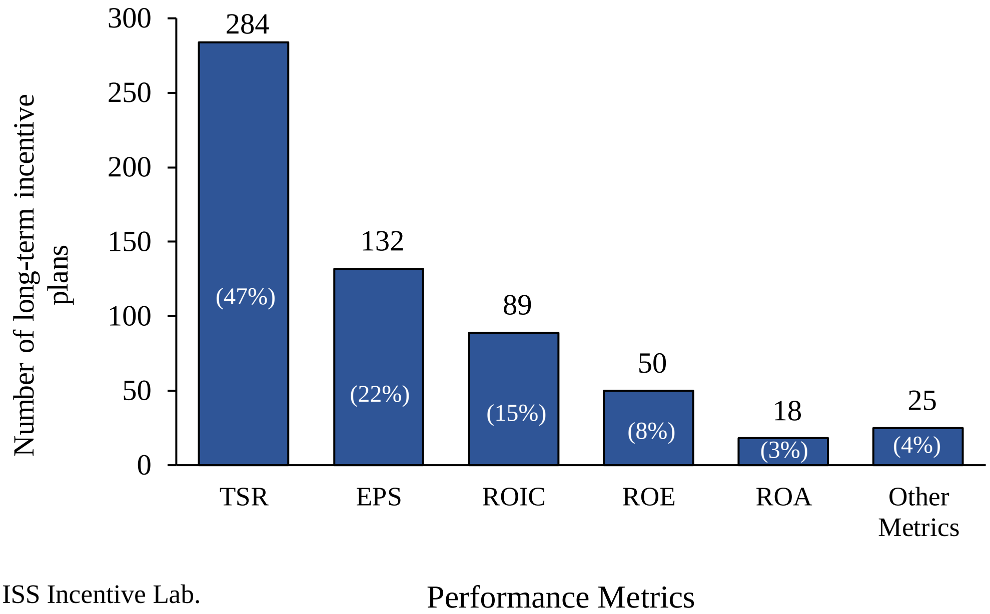
Source: ISS Incentive Lab.
Sample: Bonus grants awarded to 211 CEOs of firms included in the S&P 500 Index. Data as of Q4 2018.

B. Buybacks Can Inflect Ratings That Decide a Significant Fraction of CEO Long-Term Incentive Awards

Overall, ratings on performance criteria that buybacks can inflect are responsible for $3.7 million, or almost two thirds, of CEO long-term incentive awards (Table III). Among all the ratings, those concerning TSR are the most significant in deciding CEO long-term awards. This happens because TSR is by far the most common criterion used, deciding awards in almost half of such plans (Figure II), and because TSR decides the highest fraction of LTIP awards when they are decided by multiple criteria (Table II).

Whereas ratings on EPS are the most significant for CEO bonuses, they rank only second in their ability to increase CEO LTIP awards. They can potentially increase CEO compensation in almost one quarter of long-term incentive plans (Figure II). In such plans, EPS decides, on average, a target value of $2.65 million, or almost one half, of the award (Table II).

FIGURE II: PREVALENCE OF PERFORMANCE CRITERIA IN LONG-TERM INCENTIVE PLANS THAT BUYBACKS CAN INFLECT



Source: ISS Incentive Lab.
Sample: Based on 598 long-term incentive plans awarded to 399 CEOs included in the S&P 500 Index. Data as of Q4 2018.

TABLE II: VALUE AND WEIGHT OF CRITERIA IN LONG-TERM INCENTIVE PLANS THAT BUYBACKS CAN INFLECT*

Performance Criterion	***Average Portion of Award That the Criterion Decides***	***Average $ Value of Award That the Criterion Decides***
TSR	64%	3,737,492
ROE	58%	3,413,772
EPS	45%	2,648,616
ROIC	35%	2,060,035
ROA	32%	1,883,464

*Does not include time-vested grants.
Source: ISS Incentive Lab.
Sample: Long-term incentive awards granted to 399 CEOs of firms included in the S&P 500 Index. Data as of Q4 2018.

C. Buybacks Can Inflect Ratings That Decide a Significant Portion of Total CEO Compensation

In total, ratings that buybacks can inflect decide most (52 percent) of CEOs' incentive compensation, valued at more than $4 million (Table III). For the average CEO, this equals almost one third of total compensation. Ratings that buybacks can inflect decide $3.7 million in long-term incentive awards, a figure ten times higher than the value of the annual bonuses that they determine. The reason for this difference is that while ratings that buybacks can inflect determine almost two thirds of CEO long-term incentive awards, they decide, on average, only one fifth of CEO annual bonuses; and the value of CEO long-term incentives is three times higher than the value of CEO annual bonuses.

TABLE III: SUMMARY VALUE OF AWARDS THAT BUYBACKS CAN INCREASE

Pay Award	***Mean $ Value*** ***(Median)***	***Mean $ Value Decided by Buyback-Induced Criteria*** ***(Median)***	***Mean Weight Decided by Buyback-Induced Criteria*** ***(Median)***
Short-Term Incentives	1,903,502 (1,618,750)	356,980 (0)	19% (0%)
Long-Term Incentives*	5,885,814 (4,594,557)	3,717,032 (2,935,664)	63% (64%)
Short-Term and Long-Term Compensation*	7,855,935 (6,295,364)	4,074,012 (3,252,563)	52% (52%)
Total Compensation	13,630,296 (11,864,309)	4,074,012 (3,252,563)	30% (27%)

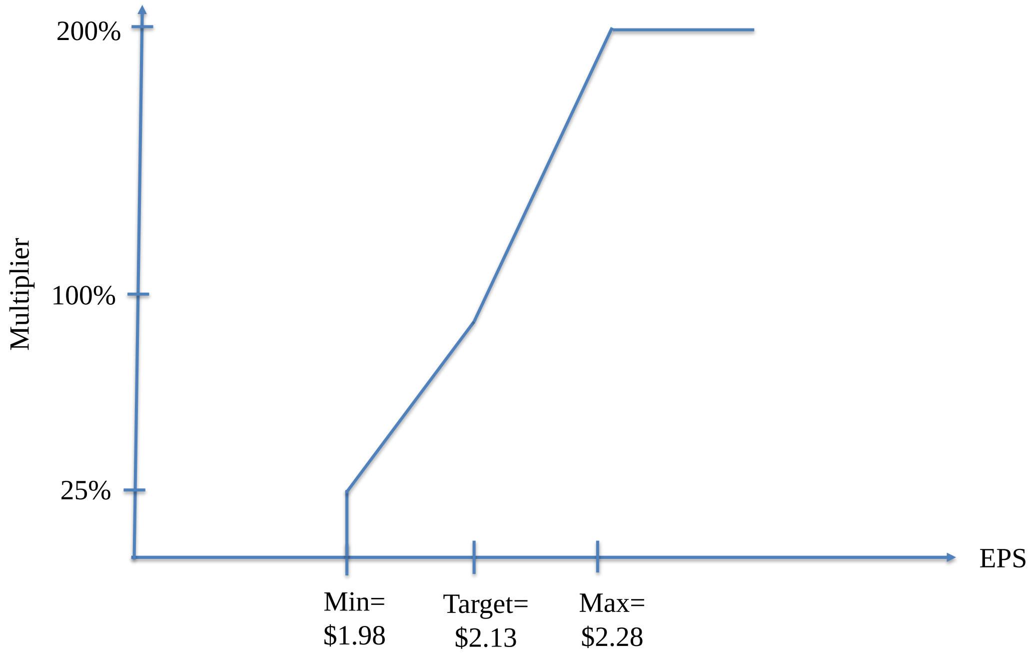
*Does not include time-vested grants.
Source: ISS Incentive Lab.
Sample: All CEOs of firms included in the S&P 500 Index. Data as of Q4 2018.

D. Small Improvements in Performance Ratings Significantly Increase Incentive Awards

When value-destroying buybacks improve ratings on performance measures, even if only marginally, they raise incentive awards considerably. This happens because the relationship between these ratings and incentive awards is not linear. Firms commonly grant incentive awards according to a graduated scheme of three predetermined performance levels: threshold, target, and maximum.[85] In order to make incentive schemes more effective, for small increases in performance between minimum and target levels, executives' rewards typically increase steeply. After a target level is met, rewards continue to increase steeply, though often at a different pace, for each percentage improvement in performance.

[85] *See* CAPITAL ADVISORY PARTNERS, 2017–2018 CAP 100 COMPANY RESEARCH, https://www.capartners.com/cap-thinking/cap-100-company-research-17-18/.

FIGURE III: AGILENT TECHNOLOGIES LONG-TERM INCENTIVE PLAN



Consider the long-term incentive plan that Agilent Technologies detailed for its senior executives in its 2020 proxy statement, represented in Figure III.[86] Half of the performance-based long-term awards of its CEO, Michael R. McMullen, was conditioned on achieving pre-determined EPS goals. The minimum EPS threshold for the CEO was $1.98; at that point he was to receive 25 percent of his payout, or $525,000. His incentives then rose sharply until EPS hit $2.13, at which point he would receive 100 percent of the payout, or $2.1 million. That is, for each percentage improvement in EPS, the CEO would receive a 10 percent increase in awards (a performance leverage of ten). Beyond that target, the payout for improved performance changed even faster, at a performance leverage rate of more than thirteen. Hence, if the CEO increased EPS performance by another 15 cents beyond target and reached $2.28, he would receive the maximum payout of $4.2 million.

To illustrate my analysis thus far, consider the hypothetical average S&P 500 CEO. Her firm repurchases roughly 4 percent of its stock outstanding per year.[87] The buyback might not harm earnings this year, but it will nonetheless immediately reduce the share count, equity, and invested capital by 4 percent and, hence, improve EPS and other per share measures. When performance leverage is ten, the 4 percent improvement in such ratings lifts the awards that they determine by 40 percent. Because buybacks can inflect ratings on criteria that decide roughly one half of the $7.8 million that the average S&P 500 CEO makes in incentive

[86] *See* Agilent Technologies Proxy Statement (Form DEF 14A) 36 (Feb. 6, 2020), https://www.sec.gov/Archives/edgar/data/1090872/000156459020003589/a-def14a_20200318.htm

[87] The largest 500 public firms in the U.S. repurchased, on average, almost 3.7 percent of their market capitalization value in buybacks during 2018 alone. *See* Martin Baccardax, *S&P 500 Returned a Record $1.26 Trillion in 2018 as Buybacks Topped $806 Billion*, THE STREET (Mar. 25, 2019), https://www.thestreet.com/investing/earnings/s-p-500-returned-a-record-1-26-trillion-in-2018-as-buybacks-topped-806-billion-14905844 (reporting that S&P 500 firms bought back a record $806.4 billion in 2018); Siblis Research, *S&P 500 Historical Total Market Cap & Float Adjusted Cap* (June 30, 2019), http://siblisresearch.com/data/total-market-cap-sp-500/ (reporting that the total market capitalization of the S&P 500 Index was about $22 trillion at the end of 2018).

compensation (Table III), the firm's buybacks can lift her annual compensation by some $3.1 million (40 percent times $7.8 million), which equals almost one quarter of the CEO's total annual compensation. Buyback decisions thus have a significant impact on CEO compensation.

E. Buybacks That Manipulate the Stock Price Increase the Value of Stock-Based Compensation

While buybacks that trigger stock price manipulation can improve TSR and the *amount* of stock-based compensation, they can also enhance the *value* of such awards. For example, suppose that a buyback manipulates the stock price and this increases from $1 to $1.10. The improvement in TSR would increase the *amount* of stock the CEO would receive under her LTIP. In addition, the stock price boost would increase the *value* of the executive's stock awards by 10 percent.[88]

Because CEOs currently receive most of their compensation in stock-based vehicles, the ability of buybacks that manipulate the stock price to inflate the value of stock-based awards can be significant for the CEO. Specifically, S&P 500 CEOs receive more than two thirds of their pay in the form of stock and stock options,[89] of which full value stocks comprise more than half of their total pay, and stock options another 15 percent.[90]

Executives' behavior signals their belief that buybacks boost the stock price, even if only temporarily. In the days before buyback announcements insiders trade in relatively small amounts—less than $100,000 worth, whereas during the eight days following buyback announcements they sell on average more than $500,000 worth of stock each day, a fivefold increase.[91] Because they can sell significant amount of their stock-based compensation almost anytime the executives stand to earn from a buyback aimed to manipulate the stock price even if the price eventually collapses. Similarly, the top executives at Lehman Brothers and Bear Stearns unloaded significant amount of their stock-based compensation at inflated prices in the years leading up to the 2008 financial crisis.[92] Regrettably, as I show in another article, the stock ownership policies that firms universally adopted in the aftermath of the 2008 financial crisis are extremely ineffectual in making CEOs hold on to their firm's stock.[93]

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[88] Because stock options are riskier and incur higher expected return than full value stock, the potential for buybacks that manipulate the stock price to change the value of executives' stock option compensation is much higher than their ability to increase the value of full-value stock awards. For gauging the impact of stock price increase on stock option valuation *see* Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 (3) J. POL. ECON. 637 (1973).

Also, because dividends tend to reduce the stock price by the dividend amount, when options and stock compensation are not dividend protected, a buyback conducted in lieu of a dividend can protect the value of stock options more than it protects full-value stock. *See* Eli Bartov, Jason Lee & Itzhak Krinsky, *Evidence on How Companies Choose Between Dividends and Open-Market Stock Repurchases*, 11 J. APP. CORP. FIN. 11, 89 (1998) (finding that companies are more likely to distribute cash to investors through open-market repurchases than through dividend increases when management compensation packages include stock options).

[89] *See* EQUILAR, INC., 2016 *supra* note 34.

[90] *Id.*

[91] *See* Jackson, *supra* note 14; *also see* Moore, *supra* note 76.

[92] *See, e.g.,* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 260 (2010).

[93] *See* Nitzan Shilon, *CEO Stock Ownership Policies – Rhetoric and Reality*, 90 (1) IND. L.J. 353 (2015).

IV. THE COSTS OF VALUE-DESTROYING BUYBACKS

When corporate executives pursue stock buybacks that sacrifice long-term firm value, elevate financial risk excessively or manipulate the stock price they impose significant costs. Such buybacks divert value unjustifiably from firms to their executives, and they are likely to significantly reduce firm value and create negative systemic consequences.

A. Value Diversion

Whether or not they are value-destroying, when stock buybacks assist corporate executives to improve the ratings on their performance metrics and increase their incentive compensation, value is diverted from firms to their executives. For example, suppose an executive is paid $1 million based on ratings that the executive received with the assistance of stock buybacks, when absent the buybacks he would have been paid only $700,000. As a result, the executive receives $300,000 that but for the buyback would have been belonged to the company.

Take Joseph Tucci, the former chairman, president, and CEO of information technology company EMC Corporation. According to a Reuters calculation, only the assistance of $3.7 billion in share repurchases moved him from achieving threshold EPS performance to meeting the $1.9 EPS required to receive his bonus goal in 2014.[94] Moreover, the improved EPS is likely to assist Mr. Tucci to receive up to additional $2.3 million in performance share units, per his long-term incentive plan.[95]

B. Value Destruction

1. The destructive consequences of short-term-driven buybacks

Short-term-driven buybacks amount to what *Forbes* has labeled "a cancer on capitalism."[96] They sacrifice innovation and long-term firm growth by undermining research and development as well as capital expenditures. The cumulative effect is to undermine the U.S. economy's competitive advantage. Take, for example, the race to develop fifth-generation wireless (5G) technology. Whereas Cisco used its repatriated cash to conduct gigantic $35 billion stock buybacks in 2018 and 2019,[97] its Chinese competitor Huawei reinvested its

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[94] *See* Bretell et al., *supra* note 45.

[95] *I.d.* at 56.

[96] *See* Denning, *supra* note 16.

[97] *See* Stefan Redlich, *Cisco Should Be More Prudent with Its Buybacks*, SEEKING ALPHA (Feb. 15, 2019), https://seekingalpha.com/article/4241493-cisco-prudent-buybacks; *see* SIMPLY WALL STREET, *Three Things You Should Check before Buying Cisco Systems for Its Dividend*, https://simplywall.st/stocks/us/tech/nasdaq-csco/cisco-systems/news/three-things-you-should-check-before-buying-cisco-systems-inc-nasdaqcsco-for-its-dividend/ (reporting that in 2019 Cisco returned around 7.9% of its market capitalization to shareholders in the form of stock buybacks).

tremendous profits in 5G technology[98] That investment helped Huawei take the lead over Cisco and other U.S. tech companies.[99]

In addition, short-term-driven buybacks promote social inequality. Their sacrifice of long-term investment includes investment in human capital, which impairs employee productivity. Lower productivity creates stagnant wages and job growth,[100] exacerbating the economic and social inequality already heightened by higher executive pay. Against this backdrop Democratic senators Bernie Sanders and Chuck Schumer have proposed bills to limit buybacks unless certain employee rights are protected.[101]

Short-term-driven buybacks worsen an already serious problem in the U.S. economy. Former President Barack Obama labeled a "culture of short-term gain at the expense of everything else" as a major contributor to the 2008 crisis.[102] Because stock markets punish firms harshly for missing short-term earnings expectations,[103] Chief Financial Officers openly admit that they routinely sacrifice long-term shareholder value—deferring a valuable project or slashing research and development expenditures—to meet earnings expectations or to smooth reported earnings.[104]

In order to discourage executives from focusing on the short term, S&P 500 firms currently grant their CEOs 60 percent of their pay, or almost $6 million, in long-term awards.[105] But when these same pay arrangements encourage corporate myopia through buybacks, they undermine the very purpose they were supposedly tailored to achieve.

2. The destructive consequences of buybacks that impose excessive financial risk

When a company conducts buybacks that elevate its financial risk excessively, it magnifies the likelihood of defaulting on the firm's debt obligations when they become due, which would force the company into bankruptcy. Executive incentives to use buybacks for the purpose of increasing financial risk imprudently are especially concerning given that most stock buybacks are now financed by debt, which increases firms' leverage and financial risk.[106] The record level of debt financing used for stock buybacks is so high that high-yield (junk) bonds and

[98] *See* Sheela Kolhatkar, *The Economist Who Put Stock Buybacks in Washington's Crosshairs*, THE NEW YORKER (June 20, 2019), available at https://www.newyorker.com/business/currency/the-economist-who-put-stock-buybacks-in-washingtons-crosshairs (citing William Lazonick, that "Huawei is one of the most innovative companies in the world, because it retains and invests its profits"); *Huawei Spends Record $14bn on R&D*, THE IRISH TIMES (Mar. 30, 2018), https://www.irishtimes.com/business/technology/huawei-spends-record-14bn-on-r-d-1.3445620.

[99] *See* Brian Fung, *How China's Huawei Took the Lead over U.S. Companies in 5G Technology*, THE WASHINGTON POST (Apr. 10, 2019), https://www.washingtonpost.com/technology/2019/04/10/us-spat-with-huawei-explained/.

[100] *See* Lazonick, *supra* note 8.

[101] *See* Schumer & Sanders, *supra* note 10.

[102] *See* Remarks by the President on Executive Compensation, Grand Foyer, The White House, (Feb. 4, 2009); https://obamawhitehouse.archives.gov/blog/2009/02/04/new-rules

[103] *See* Corrie Driebusch, *This Earnings Season, a Miss Hurts Even More*, WALL ST. J. (April 24, 2019), https://www.wsj.com/articles/this-earnings-season-a-miss-hurts-even-more-11556107202

[104] *See* John Graham, Campbell Harvey & Shiva Rajgopal, *Value Destruction and Financial Reporting Decisions*, 62 (6) FIN. ANAL. J. 27 (2006).

[105] See Table III.

[106] *See* Larry Light, *More Than Half of All Stock Buybacks Are Now Financed by Debt: Here's Why That's a Problem*, FORTUNE (August 20, 2019), https://fortune.com/2019/08/20/stock-buybacks-debt-financed/

leveraged loans have reached over $1 trillion.[107] When the giant leveraged buybacks wave pops, it could burst the "mother of all credit bubbles" and lead to another stock market crash and recession.[108]

3. The destructive consequences of buybacks that manipulate the stock price

Buybacks' ability to manipulate the stock price harms both the efficiency and fairness of capital markets.[109] It compromises economic efficiency by attracting capital to firms that exhibit only a façade of improved returns. In doing so the manipulation inhibits the efficient allocation of capital, frustrating what buybacks should do: facilitate efficient asset reallocation by allowing the distributed money to move from firms with excess cash to firms with better investment opportunities.[110] By undermining the overall sense of fairness such manipulation warns off uninformed investors, which crowds out resources from capital markets, and reduces economic productivity.

When stock buybacks manipulate the stock price systematically they can create another stock market bubble and another market crash. The resources that firms are dedicating to their buybacks deprive them of the liquidity that might help them cope when the bubble bursts.

The SEC is in charge of preventing stock buybacks that create market manipulation. The concern that the SEC has failed to prevent this practice has led policymakers to push it to reconsider its policies in regards to stock buybacks and to tighten its safe harbor that allows them.[111] In 2015 Senator Tammy Baldwin asked Mary Jo White, then SEC Chair, to look into this issue.[112] Twenty-one Democratic senators, led by Senator Chris Van Hollen, have recently called on the SEC to tighten Rule 10b-18, which currently imposes lenient restrictions on public companies that wish to buy back their shares without fear of being charged with stock market manipulation.[113] Prominent SEC Commissioners have been receptive to this criticism. Commissioner Robert Jackson has called for an open comment period on the rule.[114] Chair Jay Clayton and Commissioner Hester Pierce have indicated support for a review and proposed imposing additional limitations that would assist in preventing stock buybacks from being used for price manipulation.[115]

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[107] *See* Pearlstein, *Beware the "Mother of all Credit Bubbles,"* THE WASHINGTON POST (June 8, 2018), https://www.washingtonpost.com/business/economy/beware-the-mother-of-all-credit-bubbles/2018/06/08/940f467c-69af-11e8-9e38-24e693b38637_story.html?noredirect=on

[108] *Id.*

[109] *See, e.g.*, Fox et al., *supra* note 68.

[110] *See, e.g.*, Liz Moyer, *Bernie Sanders and Lloyd Blankfein Get in Twitter Fight over Stock Buybacks*, CNBC News (Feb. 5, 2019), https://www.cnbc.com/2019/02/05/blankfein-hits-back-at-senators-over-stock-buybacks-the-money-doesnt-vanish.html.

[111] *See* Lazonick, *supra* note 8; Sorkin, *supra* note 71.

[112] *See* Tammy Baldwin, *Letter to Mary Jo White*, Apr. 23, 2015, https://www.baldwin.senate.gov/imo/media/doc/Baldwin%20Letter%20to%20SEC%204%2023%2015.pdf

[113] *See* Bradford, *supra* note 11.

[114] Jackson, *supra* note 14.

[115] Bradford, *supra* note 11; Morgenson & McGinty, *supra* note 11.

V. CORPORATE GOVERNANCE FAILURES ALLOW EXECUTIVES TO ACT ON THEIR UNDESIRABLE BUYBACK INCENTIVES

The analysis presented above indicates that tying executive pay to performance criteria as a means to bond managers with their shareholders and reduce managerial agency costs has failed with regard to stock buybacks. Specifically, I showed that corporate executives can improve their ratings on important performance criteria and increase their performance-based compensation significantly for conducting stock buybacks that destroy long-term firm value. They are thereby incentivized to conduct value-destroying buybacks.

The failure of pay for performance arrangements to bond the interest of executive officers with that of the shareholders around buybacks is consistent with the theory of managerial power. According to this theory, managerial power and influence have shaped executive compensation in publicly-traded U.S. companies.[116]

But the incentives that corporate executives have to pursue value-destroying buybacks would not be disturbing if they did not have the power to act on them. A key purpose of corporate governance rules is to create proper monitoring mechanisms to limit aberrant executive activities.[117] These should include a system of decision-making processes that contribute to improved corporate performance and accountability and thereby to maximizing long-term shareholder value.

Unfortunately, however, such monitoring mechanisms are lacking with regard to stock buybacks. Systemic failures in corporate governance arrangements allow executives to conduct buybacks that serve their personal preferences, even when this would destroy firm value. I explain below the power that CEOs have over buyback decisions (A), the weak incentives for corporate directors to monitor executives' buyback decisions (B), and barriers to transparency that prevent effective monitoring of buyback decisions by the shareholders (C).

A. CEOs' Decision-Making Power Over Buybacks

Executives in U.S. firms are able to exercise unchecked discretion over stock buybacks in part because, unlike in many other developed countries, authorization of buyback programs and the execution of share repurchases do not require shareholder approval.[118] If stock repurchases required shareholder approval, those that manipulate performance measures would likely be disapproved, because investors overwhelmingly follow the ISS voting guidelines, which recommend voting against buybacks that inappropriately manipulate incentive compensation metrics. [119]

Further, in contrast to the situation with dividends, boards of directors in the United States leave decisions about the level and timing of share repurchases to the sole discretion of

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[116] *See, e.g.*, BEBCHUK & FRIED, *supra* note 18.

[117] *See* Jensen & Meckling, *supra* note 22, at 308.

[118] *See* Lenore Palladino, *The $1 Trillion Question: New Approaches to Regulating Stock Buybacks*, 36 YALE J. REG. BULL. 89, 96 (2018).

[119] *See* ISS GOVERNANCE, *United States Proxy Voting Guidelines Benchmark Policy Recommendations* (November 18, 2019), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf, at 31.

corporate executives.[120] Consequently, board-approved repurchase plans are more symbolic than substantive, and buyback completions are often decoupled from the plans that boards approve.[121]

B. Directors' Weak Incentives to Monitor Buyback Decisions

In addition to their weak decision-making power over the implementation of buyback programs, corporate directors have personal incentives to turn a blind eye to buyback decisions that destroy firm value. Since such buybacks can prop up the immediate stock price, they can improve unloading conditions for the stock-based compensation of directors. Sixty percent of director compensation is currently delivered in the form of stock and option awards,[122] and the vesting periods and holding requirements that prevent the sale of such awards are short and feckless.[123] Directors are thus free to unload a significant amount of their stocks and to do so quickly. A recent report indicates that directors capitalize on the price boost that buybacks create to cash out their equity awards at an inflated value.[124] Further, for a variety of financial, social, and psychological reasons, directors in publicly traded U.S. companies benefit from acting in ways that favor executives[125] and risk punishment if they do not. For example, CEOs have considerable power over the reelection process of incumbent directors. Those who question or oppose a CEO's ability to pocket personal gains from value-destroying buybacks could therefore face an increased risk of removal.

C. Lack of Monitoring Due to Lack of Transparency

1. Lack of transparency in the boardroom

The compensation committee is the first line of defense in the corporate governance system designed to ensure that executive pay incentives relating to buybacks are aligned with maximizing firm value. Three quarters of corporate directors think that firms should exclude the impact of share buybacks on financial performance assessment.[126] They also believe that their compensation committees usually factor anticipated buyback effects into EPS targets.[127] They do not know, though, whether this is actually done. One director expressed concern,

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[120] *See* Robert C. Pozen, *The Board's Role in Share Repurchases*, BROOKING (May. 4, 2017), https://www.brookings.edu/opinions/the-boards-role-in-share-repurchases/ (noting that, in many companies, decisions about the level and timing of share repurchases are left to management, and that the board must formally approve the amount of the company's dividend but not its repurchases).

[121] *See* James Westphal & Edward Zajac, *Decoupling Policy from Practice: The Case of Stock Repurchase Programs*, 46 (2) ADMIN. SCI. Q. 202 (2001).

[122] *See* EQUILAR INC., DIRECTOR PAY TRENDS (Nov. 2018) (on file with author).

[123] *See* Nitzan Shilon, *CEO Stock Ownership Policies – Rhetoric and Reality*, 90 (1) IND. L.J. 353 (2015).

[124] *See* Jackson, *supra* note 14.

[125] *See* BEBCHUK & FRIED, *supra* note 18, at 23–27 (describing sources of executives' influence over directors in public companies).

[126] *See* Melissa Burek et al., *Paying for "The Right" Performance,* COMPENSATION ADVISORY PARTNERS, (May 16, 2019), https://www.capartners.com/news/paying-right-performance/

[127] *See* Richard Fields, Tapestry Networks, *Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution*, The Investor Responsibility Research Center Institute (IRRCI), 2 (Aug. 2016), https://www.tapestrynetworks.com/sites/default/files/publication_pdf/IRRCI%20-%20Buybacks%20and%20the%20Board%20-%20August%202016.pdf (in this study, Tapestry Networks interviewed 44 directors serving on the boards of 95 publicly traded U.S. companies with an aggregate market capitalization of $2.7 trillion).

saying: “It is something that the compensation committee should be aware of and adjust for, but I don’t personally know what they’ve done.”[128]

Regrettably, compensation committee discussions and decisions on the implications of stock buybacks on executive pay remain largely in the dark and, hence, unchecked. Independent directors who are not members of compensation committees complain that these committees do not reveal the implications of stock buybacks to the full board, which is therefore not prepared to discuss them. In a recent IRRC study, one director noted: “It can be unpopular to discuss compensation implications of buybacks. I expect those discussions are happening in the compensation committee and less often at the full board. I do not see the issues discussed as openly as I might like.”[129] Moreover, independent board members who are concerned about compensation implications typically do not serve on compensation committees.[130]

Stock exchange rules instituted to make compensation committees independent of management, may inadvertently contribute to the lack of transparency in the boardroom. In order to prevent inside directors—executive officers and other directors who are not independent from management—from intervening in executive compensation decisions, stock exchange rules prohibit inside directors from serving on the compensation committee,[131] and compensation committees must determine and approve the CEO’s compensation without involving the full board, where inside directors serve.[132] Yet, as a result of corporate governance reforms, corporate boards today are overwhelmingly independent[133] and many independent directors do not serve on the compensation committee. Because of the stock exchange restrictions, these independent directors are unable to oversee the firm’s compensation policy and ensure that the firm rewards executives for desired behavior rather than for manipulating performance metrics and stock prices.

2. Lack of transparency to public shareholders

Firms do not publicly disclose to their shareholders whether they adjust executive compensation to account for repurchases. Moreover, firms do not disclose their buyback activity in a timely and complete manner.

a. Failure to disclose adjustment policies

When firms set executive compensation targets, they can already estimate what their current buyback program is going to add to EPS and other per share criteria. Firms could thus set performance targets to reflect their estimate. If firms adjusted performance targets to reflect their planned buybacks, they could prevent executives from pocketing the extra compensation derived from the improvement in performance measures that the buyback might trigger. Further, firms could adjust their performance targets for their unplanned share buybacks. Doing

[128] *Id.*

[129] *Id.*

[130] *See* Fields, *supra* note 127.

[131] See NYSE Listed Company Manual Section 303A.02; NASDAQ Listed Company Manual Section 5605(a)(2).

[132] *See* NYSE Listed Company Manual Section 303A.05; *See* NASDAQ Listed Company Manual Section 5605(d).

[133] See Spencer Stewart Inc., *2020 United States Board Index Report, available at* https://www.spencerstuart.com/research-and-insight/us-board-index, at 11 (reporting that 85% of S&P 500 directors are now independent).

so would not only prevent overpaying their executives, but would also neutralize their incentives to conduct value-destroying buybacks that increase their pay.

But only twenty S&P 500 companies currently disclose adjustment policies.[134] These firms include IBM,[135] FedEx,[136] GameStop,[137] and Johnson & Johnson.[138] The IBM policy states:

> [T]he Committee has determined that actual operating EPS results will be adjusted to remove the impact of any change from the budgeted share count, including share repurchase transactions. This method formalizes the Committee's longstanding intention of not having unplanned share repurchase practices affect executive compensation.[139]

Unlike IBM, the multinational conglomerate 3M agreed to reveal that it does not have an adjustment policy only after it was forced to respond to a pointed shareholder proposal by impact investors urging it to exclude the effect of buybacks on executive pay.[140] 3M chose not to exclude the impact of repurchases on performance targets, even though repurchases can significantly improve EPS growth, which determines much of the $4.7 million incentive compensation of its Chairman, CEO, and President, Inge Thulin.[141] The company has summarily dismissed the proposal, stating obscurely that:

> The Board believes it is not in the best interests of 3M or its stockholders for the Board to adopt a policy that the Company shall exclude the impact of share repurchases when determining senior executive incentive compensation.[142]

Firms do not disclose whether they exclude the impact of share buybacks on performance metrics that decide executive pay in part because current disclosure rules, mandated by Regulation S-K, allow them to avoid disclosure. They could nonetheless disclose information not required by current disclosure rules. Yet they seem to follow a "lawyerly approach" and reveal no information.

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[134] *See* Bretell et al., *supra* note 45 (indicating that, based on the share count before the buybacks, EPS would have been only $1.81).

[135] *See* International Business Machines Corporation Proxy Statement (Form DEF 14A) 24 (Mar. 1, 2016), https://www.sec.gov/Archives/edgar/data/51143/000110465916102981/a16-2282_1def14a.htm.

[136] *See* FedEx Corporation Proxy Statement (Form DEF 14A) 47 (Aug. 13, 2018), https://www.sec.gov/Archives/edgar/data/1048911/000120677418002406/fedex3330721-def14a.htm.

[137] *See* GameStop Corp. Proxy Statement (Form DEF 14A) 24 (June 26, 2018), http://news.gamestop.com/static-files/81337cc4-e77b-4c55-bc93-cdff9d0e8aaf.

[138] The Johnson & Johnson performance share units plan adjusts the EPS criterion if a buyback impacts adjusted operational EPS results by more than 1%. *See* Johnson & Johnson Inc., Proxy Statement (Form DEF 14A) 55 (Mar. 13, 2019), https://www.sec.gov/Archives/edgar/data/200406/000020040619000013/a2019jnjproxy.htm.

[139] *See* International Business Machines Corporation Proxy Statement (Form DEF 14A) 24 (Mar. 1, 2016), https://www.sec.gov/Archives/edgar/data/51143/000110465916102981/a16-2282_1def14a.htm.

[140] *See* 3M Company Proxy Statement (Form DEF 14A) 78 (Mar. 23, 2016), https://www.sec.gov/Archives/edgar/data/66740/000120677416005067/threem_def14a.htm.

[141] *See* 3M Company Proxy Statement (Form DEF 14A) 78 (Mar. 23, 2016), https://www.sec.gov/Archives/edgar/data/66740/000120677416005067/threem_def14a.htm.

[142] *See* 3M Company Proxy Statement (Form DEF 14A) 78 (Mar. 23, 2016), https://www.sec.gov/Archives/edgar/data/66740/000120677416005067/threem_def14a.htm.

b. Flawed disclosure of company buyback activity

As discussed in Part II.C.1, lapses in disclosure rules allow public firms to avoid the reporting of stock buyback executions until their next quarterly filing, and even then they are only required to report monthly aggregated amounts rather than daily activity.

3. Impaired monitoring due to the lack of transparency

If firms believed that the incentives they provided to their executives in connection with buybacks were desirable, they would be interested in using them as a selling point. This could lead to a higher stock price and firm value. Instead, firms hide this information because they cannot justify their practices.

Leaving investors in the dark as to the existence of adjustment policies is troubling. As explained in Part II, absent such policies executives are incentivized to conduct buybacks that they know may destroy firm value. Not knowing whether firms exclude the impact of buybacks on executive pay hinders investors from correctly assessing executives' buyback incentives. When the shareholders cannot tell executives' buyback incentives, they are unable to know whether they need to engage with the company in order to fix such incentives and whether they need to monitor executives' buyback decisions affected by their flawed incentives.

In addition, the flawed disclosure of buyback activity denies investors the information necessary to calculate how much an executive's pay benefits from buybacks, and therefore whether the level of the executive's incentive to undermine their interests justifies their monitoring and intervention. Because, as mentioned above, accounting rules require calculating EPS based on the weighted average of the number of outstanding shares over the measurement period,[143] investors need to know daily buyback activity in order to calculate the EPS that the executive would have attained without the buyback, and therefore to calculate the improvement in EPS and in pay that the buyback provided. The current disclosure rules do not provide them such information. A similar problem applies to other per share criteria.

Firms take advantage of shareholder collective action problems to avoid shareholder intervention in the buyback incentives they provide to their executives and to hide their potentially unsuccessful management of the impact of repurchases on executive pay. Shareholders in U.S. public firms are typically dispersed and diversified such that each of them holds individually only a small fraction in their portfolio companies. Consequently, while each of the shareholders must incur the full costs of pressing a portfolio company to fix the pay incentives it provides to its executives around buybacks or to disclose information pertaining to such incentives, each will reap only a tiny fraction of the added value from such intervention and thus be adverse to incurring the expense.[144]

Hiding the management of pay incentives related to stock repurchases disenfranchises shareholders by preventing a potential backlash when they cast Say on Pay votes. Since Say on Pay has been the dominant influence on conversations in compensation committee rooms, hiding information that might trigger a backlash forgoes the opportunity for a constructive

[143] *See* ERNST & YOUNG, *Earnings Per Share* (August 2019), https://www.ey.com/publication/vwluassetsdld/financialreportingdevelopments_bb1971_earningspershare_14august2019-v3/$file/financialreportingdevelopments_bb1971_earningspershare_14august2019-v3.pdf

[144] *See generally* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (2nd ed. 1971) (explaining collective action problems).

dialogue among boards, shareholders, and compensation consultants on the desirability of executive pay incentives connected to share repurchases.

Leaving investors in the dark also prevents them from knowing whether directors discharge their duties properly in monitoring executives and keeping the interests of shareholders in mind regarding buybacks. Nor does it allow them to know whether their interests are reflected in the directors' philosophy relating to share repurchases.

Finally, lack of disclosure precludes proxy advisory firms such as ISS and Glass Lewis from rewarding firms for having policies that do not allow the use of buybacks to manipulate incentive compensation metrics. As mentioned above, ISS already has such a policy.[145] Unfortunately, lack of disclosure prevents investors from knowing whether their firms allow such manipulation, rendering the ISS recommendation to object to such buybacks toothless.

D. The Suboptimal Monitoring Incentives of Short- and Long-Term Investors

Shareholders are supposed to be highly motivated to ensure that the interests of corporate executives concerning buybacks are aligned with their own. Because shareholders are the residual claimants of a firm's assets, the incentives that encourage executives to conduct value-destroying buybacks ultimately result in harm to shareholders.

Lack of transparency, collective action problems, and the weak power that shareholders have regarding buybacks reduce the likelihood that disgruntled shareholders will take action. Yet, shareholders could use their leverage to exert pressure on firms to make executives' pay incentives connected with buybacks align with shareholder interests and to make such incentives transparent. Such leverage could build on management's need to appease shareholders before they cast Say on Pay votes on executive compensation. In addition, the shareholders could exert pressure on firms by negotiating with management privately,[146] by launching "Vote No" campaigns that target the reelection of compensation committee chairs or members,[147] and by submitting shareholder proposals under Rule 14a-8.

I explain below that short-term shareholders do not push firms to change executives' buyback incentives, because such incentives oftentimes serve their short-term interests. I also explain that although long-term shareholders are supposed to be motivated to pressure firms to align executives' buyback incentives with long-term value maximization, agency problems between long-term asset managers and their beneficiaries preclude an effective intervention.

1. Short-term investors

Many value-destroying incentives of corporate executives in relation to buybacks serve the interests of short-term investors. Specifically, short-term shareholders profit from short-term-

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145 *See* ISS GOVERNANCE, *United States Proxy Voting Guidelines Benchmark Policy Recommendations* (November 18, 2019), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf, at 31.

146 *See* James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 761 (1995).

147 *See* Randall Thomas & Kenneth Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67(4) U. CIN. L. REV. 1021 (1999) (noting that since the stratospheric increases in CEO pay of the 1990s, outraged investors have made their views known to corporate boards of directors using shareholder proposals, binding bylaw amendments, "Just Vote No" campaigns, and other activist efforts).

driven buybacks because the pursuit of short-term value often increases the value of their investment, and the sacrifice of long-term value that such buybacks impose commonly takes effect only after they unwind their positions.

Hedge funds, which are commonly accused of short-termism,[148] are also blamed for pushing firms to pursue short-term-driven buybacks.[149] Consider Deutsche Börse's failed bid to take over its rival, the London Stock Exchange.[150] Hedge funds that had acquired large stakes in Deutsche Börse, such as TCI and Atticus Capital of New York, opposed the deal and demanded that cash be distributed instead to shareholders in the form of stock buybacks and dividends.[151] The funds were accused of discarding a valuable long-term investment for an immediate buyback that would pump up the short-term stock price. Similarly, Carl Icahn's high-profile campaign that successfully persuaded Apple to increase its buyback program from $60 billion to $150 billion[152] was attacked as hindering Apple's ability to innovate and make long-term valuable acquisitions.[153]

Hedge funds are further criticized for pushing firms to conduct buybacks that elevate financial risk excessively and manipulate the stock price. The modus operandi for hedge funds, the argument goes, is to pressure firms to load themselves up with debt, then to use the proceeds to buy back shares and drive their price higher so that the hedge fund can cash out fast at a high profit.[154]

The success of hedge funds in pushing firms to increase their buyback activity leads firms that have not yet been attacked by hedge funds to conduct buybacks preemptively for fear of activist intervention.[155] This phenomenon caused former Democratic presidential candidate Hillary Clinton to attack buybacks as made only to please activist hedge funds.[156] Similarly, commentators reason that the huge gap in the scale of buyback activity between the United States and Europe is due to the much higher prevalence of activist investors in the United States.[157]

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[148] *See, e.g.*, Marcel Kahan & Edward Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 PENN. L. REV. 1021 (2007).

[149] *See* GOLDMAN SACHS, *Top of Mind*, *Buyback Realities*, Issue 77, p. 14 (Apr. 11, 2019), https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf

[150] *See* Patrick Jenkins & Norma Cohen, *Deutsche Börse Courts LSE for European Exchange Union*, FIN. TIMES (London), Dec. 14, 2004, at 23.

[151] *See* David Reilly & Edward Taylor, *Deutsche Boerse Ends Bid to Purchase LSE,* WALL ST. J. (March 7, 2005), https://www.wsj.com/articles/SB111014277117371558

[152] *See* Chuck Jones, *Carl Icahn Sold Apple Too Soon & It Cost Him $3.7B*, FORBES, Nov. 10, 2017, https://www.forbes.com/sites/chuckjones/2017/11/10/carl-icahn-sold-apple-too-soon-it-cost-him-3-7b/#ab463f32cea7

[153] *See* Alex Rosenberg, *How Icahn Lost the Battle—But Won the Apple War*, CNBC (Feb. 10, 2014) https://www.cnbc.com/2014/02/10/how-icahn-lost-the-battlebut-won-the-apple-war.html

[154] *See* Denning, *supra* note 16.

[155] *See* Edward Luce, *US Share Buybacks Loot the Future*, FIN. TIMES (Apr. 26, 2015), https://www.ft.com/content/1aaac576-e9bb-11e4-a687-00144feab7de

[156] *See* Francine McKenna, *Clinton and Surrogates Criticize Share Buybacks—Even as the Trend Reverses*, MARKET WATCH, Aug. 24, 2016, https://www.marketwatch.com/story/clinton-and-surrogates-criticize-share-buybacks-as-trend-has-reversed-2016-08-23

[157] *See* GOLDMAN SACHS, *Top of Mind*, *Buyback Realities*, Issue 77, p. 16 (Apr. 11, 2019), https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf

2. Long-term investors

For several reasons long-term shareholders stand to lose from executives' incentives to conduct short-term-driven buybacks and from those that manipulate the stock price. First, they typically do not sell their stock early enough to enjoy the short-term performance improvement and stock price appreciation that such buybacks can create. Second, they are likely to stay with the firm long enough to suffer the long-term adverse consequences of such corporate actions. Third, because these buybacks can unduly increase the short-term stock price, a stock may unjustifiably be included in an index. Consequently, long-term investors, which typically diversify their portfolios through investment in indexes, are forced to invest in that stock. When the long-term consequences of such buybacks emerge and the stock price plummets, long-term investors suffer the full destructive value of such buybacks.

The rhetoric of Larry Fink, chief executive of BlackRock, the world's biggest long-term asset manager worldwide, fits the interests of its beneficiaries in preventing short-term-driven buybacks. Mr. Fink sent letters to leading CEOs expressing concern about such buybacks. In one letter he explained that:

> Many companies continue to engage in practices that may undermine their ability to invest for the future . . . We certainly support returning excess cash to shareholders, but not at the expense of value-creating investment.[158]

In another letter Fink stresses his concern about short-term-driven buybacks:

> Too many companies have cut capital expenditure and even increased debt to...increase share buybacks.[159]

Index funds have considerable power to push their agenda and preferences onto their portfolio companies. BlackRock, Vanguard, and State Street (known as the "Big Three"), the biggest long-term asset managers globally, together constitute the largest shareholder in 88 percent of all S&P 500 firms.[160] They could therefore effectively pressure firms to align their executives' buyback incentives with the interests of long-term shareholders and to make such incentives transparent.

Unfortunately, despite their rhetoric and the interests of their beneficiaries, index funds overwhelmingly support buybacks proposed by management.[161] Moreover, although in a few instances U.S. firms require shareholder approval for buyback programs, the Big Three do not pressure managements to put buybacks up for vote by shareholders.

The voting pattern of index fund managers around buybacks is consistent with their general agency problems vis-à-vis their own investors.[162] Such investment managers generally capture

[158] *See* Laurence D. Fink, *2014 Letter to CEOs*, February 1, 2016, https://www.blackrock.com/corporate/en-us/literature/press-release/ldf-corp-gov-2016.pdf.

[159] *See* Laurence D. Fink, *2014 Letter to CEOs,* March 21, 2014, https://www.blackrock.com/corporate/investor-relations/2014-larry-fink-ceo-letter

[160] *See* Jan Fichtner, Elke Heemskerk & Javier Gracia-Bernardo, *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk,* 19 (2), BUS. & POL. 298 (2017).

[161] *Id*.

[162] *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy,* 119 COLUM. L. REV. 2029 (2019).

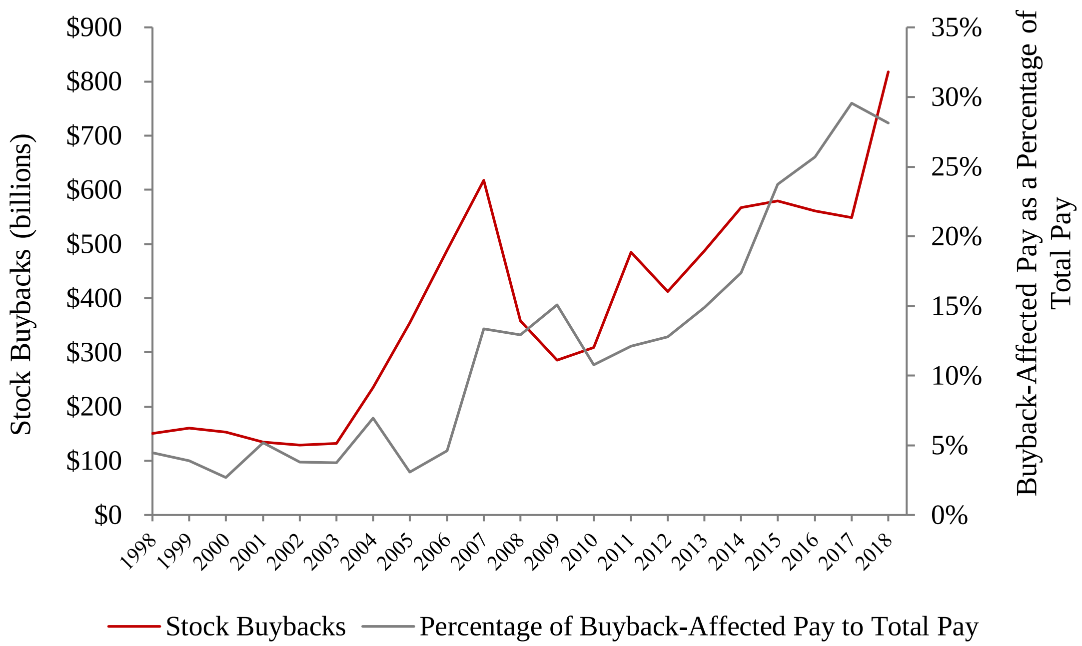
only a small fraction of the benefits that results from their stewardship activities while bearing the full cost of such activities. Also, investment managers may be influenced by private incentives, such as their interest in obtaining business from corporations, that encourage them to side excessively with managers of corporations.

Consistent with their agency problems and their general indifference to managers' decisions, index fund managers are motivated to underinvest in stewardship and defer excessively to corporate managers.[163] For example, the Big Three largely outsource their discretion on corporate decisions, including buybacks, to proxy voting advisors such as ISS and Glass Lewis.[164] They devote limited personnel time to stewardship, privately communicate with only a small minority of portfolio companies, and focus disproportionately on divergences from governance principles.[165]

E. Buyback Activity is Consistent with Executives' Perverse Incentives Around Buybacks

Against the backdrop of the corporate governance impediments for effective monitoring detailed above, it should come as no surprise that a firm's repurchase activity is consistent with the preferences and interests of its corporate executives. In my survey of all compensation arrangements of CEOs included in the S&P 500 Index, I find a very high correlation (81 percent) between the amount firms allocate to stock buybacks and the portion of CEO pay that buybacks can influence. Put differently, the greater the ability buybacks have to increase CEO pay, the more buybacks firms conduct (Figure IV).

FIGURE IV: BUYBACK ACTIVITY INCREASES WITH ITS ABILITY TO INCREASE CEO PAY



Source: ISS Incentive Lab, Compustat.
Sample: All firms included in the S&P 500 Index.

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[163] *Id.*

[164] *Id.*

[165] *Id.*

In addition, I find that buybacks rise with CEO pay incentives not only in time series data, but also in cross-sectional data. I rank all firms included in the S&P 500 Index by the ability of stock repurchases to increase CEO compensation. I measure such ability by the percentage of CEO pay decided by criteria that repurchases can improve, such as EPS and TSR. Compared to the bottom 20 percent, firms in the top 20 percent of those where buyback ability increases CEO pay allocate three times more of their net income to stock buybacks. This result is statistically significant (Mann-Whitney test, $p = 0.0275$).

VI. PROPOSED REMEDIES

Because, as I have shown: (i) stock buybacks are booming to a record level equal to roughly total company earnings; (ii) value-destroying buybacks can increase executive compensation considerably; hence, they give executives the incentive to conduct them; and (iii) corporate governance failures provide managers with the power to act on their undesirable incentives, it is imperative to find remedies to address the undesirable incentives and failing corporate governance arrangements that allow this reality. I turn now to discuss possible responses.

A. Existing Proposals and their Inadequacies

Shareholder activists have recently begun to push public firms to exclude the impact of share buybacks on executive compensation. They have submitted proposals to this effect in leading U.S. public firms such as General Electric,[166] Wal-Mart,[167] Cisco Systems,[168] American Express,[169] Boeing,[170] 3M,[171] Illinois Tool Works, and Xerox.[172]

A group of shareholder activists, led by James McRitchie and John Chevedden, has pushed IBM to ignore, for the purpose of calculating EPS and other per share performance

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[166] *See* General Electric Company, Proxy Statement (Form DEF 14A) 62 (Mar. 12, 2018), https://www.sec.gov/Archives/edgar/data/40545/000120677418000752/ge3334621-def14a.htm#a62DeductImpactofStockBuybacksfromExecutivePay.

[167] *See* Kristopher A. Isam, Wal-Mart Stores, Inc., Letter to SEC regarding Wal-Mart Stores, Inc., shareholder proposal of Amalgamated Bank's Long View Large Cap 500 Index Fund, Exchange Act of 1934-Rule I 4a-8 (Jan. 29, 2016), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/amalgamatedbanks012916-14a8-incoming.pdf.

[168] *See* Cisco Systems Inc., Proxy Statement (Form DEF 14A) 68 (Oct. 24, 2018), https://www.sec.gov/Archives/edgar/data/858877/000119312518306418/d611307ddef14a.htm.

[169] *See* American Express Inc., Proxy Statement (Form DEF 14A) 83 (Mar. 15, 2019), https://ir.americanexpress.com/Cache/1500118573.PDF?O=PDF&T=&Y=&D=&FID=1500118573&iid=102700.

[170] The Boeing Company, 2009 Proxy Statement (Mar. 13, 2009), http://services.corporate-ir.net/SEC.Enhanced/SecCapsule.aspx?c=85482&fid=6209767.

[171] Cydney S. Posner, *Shareholder Proposals to Exclude the Impact of Buybacks from Executive Comp Metrics — Will They Become a New Trend?*, Cooley PubCo (Apr. 12, 2016), https://cooleypubco.com/2016/04/12/shareholder-proposals-to-exclude-the-impact-of-buybacks-from-executive-comp-metrics-will-they-become-a-new-trend/ (referring to AFL-CIO shareholder proposals submitted at 3M, Illinois Tool Works, and Xerox proxy statements in 2016).

[172] In line with the thesis developed in this article, the proponents of these shareholder proposals reason that certain financial metrics used for setting executive pay can be inflated by stock buybacks in the short term. If companies do not exclude the impact of stock buybacks from the compensation formulas used for their senior executives, the shareholder proposals explain, managers would have incentives to conduct excessive buybacks, which would reward them for financial manipulation and hurt firms' capital expenditures and long-term health. *See* The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), Shareholder Advocacy, https://aflcio.org/what-unions-do/social-economic-justice/shareholder-advocacy.

criteria, the reduction in share count that a buyback triggers (the Exclusion Approach). Specifically, they suggested that the IBM board:

> [A]dopt a policy that it will not utilize earnings per share, or its variations, or financial ratios, in determining a senior executive's incentive compensation or eligibility for such compensation, unless the board utilizes the number of outstanding shares on the beginning date of the performance period and excludes the effect of stock buybacks that may have occurred between that date and the end of the performance period.[173]

Other firms have taken a different approach to account for the impact of stock buybacks on EPS. They have agreed to exclude the reduction in share count triggered by stock buybacks only insofar as such buybacks were unplanned (the Budgeting Approach).[174] IBM, Fedex,[175] and Qualcomm[176] have adopted policies consistent with this approach. The IBM policy states that:

> [T]he Committee has determined that actual operating EPS results will be adjusted to remove the impact of any change from the budgeted share count, including share repurchase transactions. This method formalizes the Committee's longstanding intention of not having unplanned share repurchase practices affect executive compensation.[177]

In order to illustrate the functioning of the Exclusion and the Budgeting Approaches, consider a company with $100 periodic earnings and 110 shares outstanding in the beginning of the measurement period. It plans to repurchase 10 shares but nonetheless buys back 20 shares. According to the Exclusion Approach, the EPS for executive pay purposes should be based on a share count of 110, reducing the EPS mark from $100/90=1.11 to $100/110=$0.91. Conversely, the Budgeting Approach would only ignore the unplanned repurchase of 10 shares. Therefore, it would impute a share count of 100, reducing the EPS mark only to $100/100=$1. Yet, the two approaches would lead to the same outcome, whether the board were to follow the Budgeting Approach and make ex-ante adjustments to reflect the expected impact of planned buybacks on EPS targets or, alternatively, to follow the Exclusion Approach and make no such ex-ante adjustments.

If either of these two approaches were desirable for all firms, the SEC should have integrated them into its Rule 10b-18, which defines the conditions under which firms can buy back their shares without fear of being charged with stock market manipulation. Specifically,

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173 *See* Matt S. McNair, SEC, response letter to Stephen L. Burns concerning a shareholder proposal submitted to IBM by James McRitchie for inclusion in the Company's proxy materials for its upcoming annual meeting of security holders (Jan. 17, 2018), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2018/mcritchiechevedden011718-14a8.pdf.

174 *See* Fields, *supra* note 127**.**

175 *See* FedEx Corporation Proxy Statement (Form DEF 14A) 47 (Aug. 13, 2018), https://www.sec.gov/Archives/edgar/data/1048911/000120677418002406/fedex3330721-def14a.htm.

176 *See* Qualcomm Inc. Proxy Statement (Form DEF 14A) 32 (Jan. 24, 2019), https://www.sec.gov/Archives/edgar/data/804328/000120523319000009/proxy2019.htm.

177 *See* International Business Machines Corporation Proxy Statement (Form DEF 14A) 24 (Mar. 1, 2016), https://www.sec.gov/Archives/edgar/data/51143/000110465916102981/a16-2282_1def14a.htm.

the SEC could have limited the application of this "safe harbor" to firms that bind themselves to one of these approaches

Unfortunately, however, both the Budgeting Approach and the Exclusion Approach are flawed and undesirable. First, the impact of a buyback on earnings can vary greatly across firms. Consider, for example, two firms, A and B, with $100 periodic earnings and 100 shares outstanding at the beginning of the measurement period. Both firms will make an unplanned repurchase of 10 shares at the same time during the measurement period. Hence, according to both approaches EPS should be corrected from $100/90=$1.11 to $100/100=$1.

Yet, it could be that the buyback reduced the ability of firm A to generate earnings during this period, say by $10, but did not harm the ability of firm B to do the same. This could happen, for example, when the buyback money forced firm A to cut its advertising budget, but the buyback money in firm B was either free cash flow or an investment that was not supposed to generate income during the current period. Absent the buyback firm A would have achieved an EPS of $110/100=$1.1 and firm B would have an EPS of $100/100=$1.

Both the Budgeting Approach and the Exclusion Approach force each firm to impute an EPS of $1. Clearly, their approach is flawed in regards to firm A. In essence, these approaches work well only when the buyback does not impact the ability of the firm to generate profits during the measurement period in which the buyback is conducted. This hard assumption, as my example illustrates, is wrong.

Second, both the Budgeting Approach and the Exclusion Approach punish firms that conduct desirable buybacks, those that increase firm value. If firm B used free cash flows to sponsor its buyback, the improved $1.11 EPS that it achieved would reflect a real improvement in its capital efficiency, and the executives should be incentivized to execute such a move. Unfortunately, both approaches remove this desirable incentive.

Third, both approaches miss the offsetting impact on share count provided by new stock issuances. Consider the example above, but now assume that firms A and B issue new 10 shares. In this case the new stock issuance fully offsets the impact of the buyback on the number of shares outstanding. Ignoring new issuances would commonly amount to a material omission, because new stock issuances make up more than 80 percent of stock repurchases.[178]

Fourth, at best these approaches may offset the impact of buybacks on EPS and other per share performance metrics, but they do not address the impact of buybacks on other performance measures such as TSR.

B. Improving Managers' Buyback Incentives Through Corporate Governance Mechanisms

Adjusting performance targets appropriately requires specialized knowledge about the expected impact of buybacks on earnings in the case of their impact on EPS, and, similarly, about their impact on the stock price in regards to TSR. I therefore do not support a one-size-fits-all solution. Instead, I propose a corporate governance solution that would push

[178] *See* Fried & Wang, *supra* note 54 (reporting that during the period 2005-2014, S&P 500 firms distributed to shareholders more than $3.95 trillion through stock buybacks, but also absorbed, directly or indirectly, $3.4 trillion of equity capital from shareholders through share issuances).

compensation committees, which typically have the specialized knowledge and which are at least formally independent, to think proactively about this aspect of compensation design, and that would enable the shareholders, assisted by proxy advisory firms, to check their decision.

In particular, I suggest requiring firms to clearly disclose how they address the impact of stock buybacks, planned and unplanned, on the performance targets they set for executive compensation purposes. Firms should further be required to submit such information for a shareholder referendum by adding it to the arrangements approved by shareholders in their "Say on Pay" advisory votes.

This requirement should be implemented by revising Regulation S-K, Item 402, to require firms to provide clear, concise, and understandable disclosure of: (i) the performance measures used by the company to determine CEO pay that buybacks can improve even without increasing firm value; (ii) the portion of CEO pay decided by such performance criteria; and (iii) whether the company has a policy that aims to offset, exclude, or reduce the impact of stock buybacks on executives' ratings on such performance measures. Because firms are required to approve executive compensation in their "Say on Pay" votes, as disclosed pursuant to Item 402 of Regulation S-K,[179] revising this regulation would suffice to have the shareholders vote on such additional information.

I expect that better transparency related to the impact of stock buybacks on executive pay and requiring shareholders to vote on the firm's proposed accounting of such impact should improve the way that firms address this issue. This would push compensation committees to take actions to improve their accounting of the impact of buybacks on executive pay. Currently, the lack of disclosure around this matter allows compensation committee members to ignore it. The lack of any disclosure requirement keeps the problem hidden from the members, who are part-time nonemployees with limited time for their duties and abundant responsibilities. Because boards and compensation committees, even if loyal and dedicated, are unable to analyze the hidden aspects of all corporate policies, making the impact of buybacks on pay transparent should provide them with the information they need to evaluate the severity of this issue and alert them to problems that are currently hidden.

A robust transparency requirement should improve compensation committees' action even when they are disloyal to investors. Anticipation of the outrage that would accompany a disclosure that a firm was allowing its CEO to enrich him, or herself, for conducting value-destroying buybacks,[180] would push compensation committees to account for stock buybacks when they set performance criteria goals, in order to avoid embarrassment and the social costs associated with endorsing executive pay arrangements that ignore the impact of stock buybacks on pay. Past experience indicates that negative social impacts can significantly affect directors' behavior. For example, boards were more likely to remove executives responsible for stock option backdating when there was greater media attention.[181]

Better disclosure would also encourage action by long-term asset managers, those

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[179] *See* 17 CFR § 240.14a.

[180] Outrage costs are the social and economic costs that managers suffer when outsiders perceive certain pay arrangements as unjustified or even abusive or "outrageous." *See* BEBCHUK & FRIED, supra note 18, at 65.

[181] *See* Margarethe F. Wiersema & Yan Zhang, *Executive Turnover in the Stock Option Backdating Wave: The Impact of Social Context* (Mar. 2011) (unpublished manuscript) (presented at the 2011 University of Missouri Corporate Governance Conference), http://muconf.missouri.edu/corporate_governance/abstracts/Session%205%20%20Zhang%20Conference%20Paper.pdf.

investing on behalf of beneficiaries with a strong interest in discouraging short-term-driven buybacks, as it would alleviate their agency and collective action problems by providing them with the processed information that they need to pressure firms to address the impact of stock buybacks on executive pay. It would also help these professional money managers, who commonly hold diversified portfolios across the market, to identify systemic problems regarding the impact of stock buybacks on executive pay and evaluate proposed reforms. Transparency across the board would make systematic analysis available for institutions with a fairly modest investment of resources. In addition, because public firms care about receiving shareholder support for their executive compensation arrangements in Say on Pay votes, and because long-term shareholders commonly constitute a decisive majority of such votes,[182] these shareholders would have clout in making their pressure effective.

Finally, making the impact of stock buybacks on pay transparent and including it in shareholders' Say on Pay vote will greatly assist the influential proxy advisor firms to ensure that stock buybacks do not manipulate performance metrics. As indicated earlier, although shareholder votes on stock buybacks are not required in the U.S., ISS already recommends voting against stock buybacks that manipulate incentive compensation metrics.[183] Yet, because the information provided to shareholders' Say on Pay votes does not include the potential impact of stock buybacks on executive pay, ISS cannot recommend voting against executive compensation arrangements that allow manipulation through buybacks. Disclosure should enable ISS and other proxy advisory firms to make such recommendations.

CONCLUSION

Overall, I have shown that current executive compensation arrangements provide CEOs with perverse incentives to conduct stock buybacks that destroy firm value, and that such incentives impact a significant portion—approximately a third—of total CEO compensation. I have further shown that systemic corporate governance failures enable corporate executives to act on their undesirable buyback incentives, and that acting on such incentives mocks the objectives of a post-2008 financial crisis reform that conditioned CEO incentive awards on meeting performance yardsticks. Hence, I have offered a corporate governance remedy that would force firms to disclose their policies regarding the impact of stock buybacks on CEO pay. The proposed relief would also empower shareholders to respond to a firm's policy in their Say on Pay votes.

Since institutional shareholders overwhelmingly follow ISS recommendations regarding their Say-on-Pay votes, my proposal to add firms' policies related to the impact of stock buybacks on executive pay to the materials shareholders consider in their Say on Pay votes might incur the criticism that advisory firms would become the de facto regulators of such policies, and that their use of uniform voting guidelines would result in a one-size-fits-all approach. I disagree. ISS currently recommends voting case-by-case on management proposals (the approval of which is not currently required by law) to institute stock buybacks that do not

[182] *See* Fichtner et. al, *supra* note 160 (reporting that BlackRock, Vanguard and State Street constitute the largest shareholder in 88 percent of the S&P500 firms).

[183] *See* ISS GOVERNANCE, *United States Proxy Voting Guidelines Benchmark Policy Recommendations* (November 18, 2019), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf, at 31.

exclude their impact on CEO incentive compensation metrics.[184] There is no reason to believe that ISS's policy on the matter of stock buyback impact on incentive compensation metrics would be any different in the context of Say on Pay.

Others might argue that my proposed remedy does not go far enough to empower shareholders. Specifically, they might argue that requiring a binding shareholder approval for buybacks would be a more effective remedy than affixing the issue of stock buyback impact on executive pay to Say on Pay advisory, non-binding shareholder referenda. I disagree on multiple accounts with this criticism. First, the problem I detect relates to executive compensation design. As such, it should be resolved within the ambit of executive compensation regulation rather than by means of stock buyback regulation. Second, my proposal is more consistent with the general philosophy of U.S. corporate law and securities regulation, which does not allow shareholders to intervene in specific business decisions, but which does allow them to communicate to management their views on executive compensation matters. Third, my proposal is far cheaper to implement than holding a separate shareholder vote on stock buybacks. Because Say on Pay is a vote already taken, my proposal does not impose the significant costs associated with convening an additional shareholder meeting. Instead, it only requires additional disclosure, which would incur far more modest costs.

I leave for future research the empirical examination of my theoretical claims. More empirical research should be done on the long-term consequences of stock buybacks by firms that provide their CEOs with strong pay incentives to conduct short-term-driven buybacks. Likewise, future studies should investigate empirically the long-term stock price behavior of firms that provide their CEOs with strong incentives to manipulate the stock price or to lever up through buybacks.

Future research should further study, from an empirical perspective, the corporate governance implications of my analysis. Do powerful CEOs, for example those who also chair the board of directors or who are more insulated from removal, manage to act more forcefully on their undesirable buyback incentives? Do firms with greater institutional shareholder ownership provide weaker pay incentives to conduct value-destroying buybacks? Is greater activist hedge fund presence, which some have attacked as promoting short-termism, associated with stronger CEO pay incentives to conduct short-term-driven buybacks?

Furthermore, future research should reexamine the widespread belief among academics and practitioners that hedge fund activists oppose or are hostile to corporate executives' opportunistic behavior. My analysis indicates that hedge funds have incentives to collude with corporate executives and advance all three types of undesirable stock buyback discussed in the paper. Their potential collusion with corporate executives around stock buybacks has far-reaching implications for corporate governance policy and the power that corporate law should provide to activist investors.

Finally, this Article challenges the approach that guides compensation committees, proxy advisory firms, and compensation consultants, which presumes that instituting performance yardsticks can effectively align CEO incentives with maximizing firm value. The ability of CEOs to improve their ratings on performance metrics through value-destroying buybacks calls this assumption into question. Those who design executive compensation arrangements should

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[184] *See* INSTITUTIONAL SHAREHOLDER SERVICES, INC., 2020 U.S. PROXY VOTING GUIDELINES BENCHMARK POLICY RECOMMENDATIONS 54 (Nov. 19, 2020), available at https://www.issgovernance.com/policy-gateway/voting-policies/.

reassess the ability of corporate executives to manipulate performance yardsticks that determine their pay and to separate pay from performance, not only through stock buybacks but also through other business decisions. As they evaluate proposed fixes, they should include my proposal to make the impact of stock buybacks on CEO pay transparent and to include such information in Say on Pay votes.