Via Hand Delivery

October 23, 2019

The Honorable Carolyn B. Maloney
Chair
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

The Honorable Bill Huizenga
Ranking Member
Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Re: October 17, 2019 Hearing entitled: “Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors”¹

Dear Madam Chair and Ranking Member Huizenga:

I am writing on behalf of the Council of Institutional Investors (CII) to express our appreciation to you for holding the above referenced hearing and to provide you with our views on stock buybacks, including our general support for one of the draft legislative proposals discussed at the hearing. We would respectfully request that this letter be made a part of the hearing record.

CII is a nonprofit, nonpartisan association of public, corporate and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately $4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their

families. Our associate members include a range of asset managers with more than $35 trillion in assets under management.²

Stock Buybacks

Public companies are always looking for ways to invest profits to increase their future growth. At some point, they may run out of investment opportunities with enough growth potential to justify an investment. In those cases, companies may decide to use their profits in another way, to buy back shares of the company or to grant dividends. As hearing witness Craig M. Lewis explained:

Economic theory argues that new investment should only be taken if new projects are expected to earn returns that exceed the opportunity cost of capital. That is, a firm should only invest in projects that have positive net present value (NPV). Suboptimal investments - those with negative NPVs - destroy firm value. When firms do not have attractive investment opportunities, repurchasing shares is a sensible alternative to investment in negative net present value projects.³

Hearing witness Jesse M. Fried put it more succinctly: “From shareholders’ perspective, cash should be returned when the funds would generate more value for shareholders outside the firm than inside the firm.”⁴

CII believes that stock buyback decisions are, at their core, capital allocation decisions.⁵ Making it harder for companies to pursue stock buybacks could force them to sit on cash or waste it on projects with a low potential for success.⁶ This may not be the wisest use of

² For more information about the Council of Institutional Investors (“CII”), including its board and members, please visit CII’s website at http://www.cii.org.
⁵ Council of Institutional Investors, Corporate Governance Policies § 5.9b Stock Repurchase Programs (updated Oct. 28, 2018), https://www.cii.org/files/10_24_18_civ_policies.pdf (“Stock buyback decisions are a capital allocation decision”).
⁶ Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors to The Honorable Carolyn B. Maloney, Chair, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets, Committee on Financial Services, United States House of Representatives et al. 4-5 (May 4, 2019), https://www.cii.org/files/issues_and_advocacy/correspondence/2019/May%204%202019%20Letter%20to%20Subcommittee%20on%20Investor%20Protection%20Entrepreneurship%20and%20Capital%20Markets%20final.pdf (“CII believes that stock buyback decisions are, at their core, capital allocation decisions and making it harder for companies to pursue stock buybacks could force them to sit on cash or waste it on projects with a low potential for success.”); Joshua Bolton & Ken Bertsch, Opinion, Restricting Stock Buybacks Will Hurt the Economy, N.Y.
a company’s profits, as it can hurt growth and erode investor confidence. As Mr. Lewis explained:

If regulation creates incentives for firms to reinvest rather than distribute excess cash to shareholders, it would likely lead to an overinvestment problem in which firms would make inferior investments that would be unlikely to benefit the economy in the long-run.7

Moreover, the money spent on buybacks does not evaporate; it is often invested by shareowners in other companies that need capital more than the company executing the buyback. That reinvestment in a higher use creates a benefit that inures to investors and to society more broadly.8 As Mr. Lewis explained:

Another point that is often overlooked in the share repurchase debate is that the cash paid to shareholders does not disappear. Investors selling shares either spend the cash received on goods and services or reinvest it elsewhere. The reallocation of capital into consumption and other investments potentially redirects it to activities that have higher value than incremental investments available to firms. In the long-run, this stimulates growth and creates better jobs than would be possible if firms were to make suboptimal investments simply because the cash was available.9

Similarly, Mr. Fried testified:

[Stock buybacks] can benefit shareholders by enabling them to generate more value for themselves than if the cash is left in the firm. And shareholder payouts by public firms can thus benefit the economy as a whole by making capital available to smaller, growing firms that will engage in investment and hire American workers, the vast majority of whom work for private firms.10

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7 Testimony of Craig M. Lewis at 9; see, e.g., Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors: Hearing Before the Subcomm. on Inv’r Prot., Entrepreneurship, & Capital Mkts. of the H. Comm. on Fin. Servs., 116th Cong. (2019) (Testimony of Derik Dwayne Coffey, CFA, Portfolio Specialist, Channing Capital Management, LLC at 7), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-coffeyd-20191017.pdf (“legislation that is designed to restrict or limit buyback activity must be measured against negative externalities that could impair capital allocation that is critical for normal functioning markets”).

8 See, e.g., Commissioner Hester M. Peirce, Speech, Festivus, Fortnite, and Focus: Remarks before the Council of Institutional Investors Spring Conference (Mar. 5, 2019), https://www.sec.gov/news/speech/speech-peirce-030519 (commenting that buybacks may result in shareholder “reinvestment . . . in a higher use creat[ing] a benefit that inures to investors and to society more broadly”).

9 Testimony of Craig M. Lewis at 4.

10 Testimony of Professor Jesse M. Fried, Dane Professor of Law, Harvard Law School at 3.
Likewise, hearing witness Derik Dwayne Coffey testified:

Capital allocation strategies such as dividends and buybacks are typically pursued after a company’s Board of Directors has exhausted its options for deployment into initiatives such as Property, Plant and Equipment, Debt Reduction, Human Capital Investment, Research and Development, and or Mergers/Acquisitions. When capital levels exceed a company’s expenditure needs, returning this capital to shareholders is considered a prudent strategy that enables and empowers investors to redeploy excess cash to areas where there may be more attractive growth opportunities. This keeps capital flowing so that our economy is always using capital it has available as efficiently as possible.\(^{11}\)

CII has not expressed a general view on the merit of special dividends as opposed to buybacks, although particular investors may favor one approach over the other in a given case, depending on portfolio strategies and company-specific circumstances. The two approaches have significantly different tax implications for investors, which for our institutional asset owner members tends to be only an indirect concern. But we acknowledge that company management has some obligation to consider tax implications for other investors. We would note that special dividends are more transparent, which may reduce concerns around insider trading as compared with share buybacks.

CII does not believe that all stock buybacks are appropriate.\(^ {12}\) For example, we believe that companies should not repurchase their shares to boost the stock in the short term—especially if Chief Executive Officer pay is linked to earnings per share or measures of capital efficiency, such as return on equity or return on assets, which also are lifted when equity is reduced.\(^ {13}\) More specifically, we generally agree with Mr. Fried that some executives may inappropriately use buybacks:

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[T]o enrich themselves at the expense of public investors, through (1) indirect insider trading,\(^ {14}\) (2) the manipulation of the stock price and EPS
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\(^{11}\) Testimony of Derik Dwayne Coffey, CFA, Portfolio Specialist, Channing Capital Management, LLC at 2.

\(^{12}\) See Letter from Jeffrey P. Mahoney at 5 (“CII does not believe that all stock buybacks are appropriate.”); Council of Institutional Investors, CII Statement on Share Buybacks (Feb. 5, 2019), https://www.cii.org/feb5sharebuybacks (“Some buybacks are not appropriate”); see also Council of Institutional Investors, Corporate Governance Policies § 5.9b Stock Repurchase Programs (“Stock buyback decisions . . . should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans.”).

\(^{13}\) Council of Institutional Investors, CII Statement on Share Buybacks (“Companies should not repurchase their own shares to boost the stock price in the short-term—especially if CEO pay is linked to earnings per share or measures of capital efficiency, such as return on equity or return on assets, which are also are lifted when equity is reduced.”).

\(^{14}\) Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors: Hearing Before the Subcomm. on Inv’r Prot., Entrepreneurship, & Capital Mkts. of the H. Comm. on Fin. Servs., 116th Cong. (2019) (statement of Lenore Palladino, Ph.D., J.D., Assistant Professor of Economics & Public Policy,
metrics in compensation arrangements, [15] and (3) “false signaling:” announcing repurchases that executives do not intend to carry out, solely to boost the stock price before executives unload shares.16

That is why we advocate for strong corporate governance practices at public companies “guiding how the decisions about stock buybacks . . . are made, to ensure they are made with the long-term interests in mind.”17 We believe those practices may be advanced by requiring more robust disclosure of buybacks.18

H.R. ___, the Stock Buyback Disclosure Improvement Act of 2019 (Improvement Act)19

CII generally supports the Improvement Act. We note that the provisions of the Improvement Act would require public companies, when they announce a stock buyback program, to disclose whether executives at the company plan to participate in the buyback program.20 In addition, provisions of the Improvement Act would require companies, when they announce a buyback plan, to disclose how the buyback plan will affect the compensation, or elements used to determine the compensation, of the company’s executives.21

We generally agree with Mr. Fried that the provisions of the Improvement Act “could cause a firm’s board to better focus on certain aspects of their repurchase and compensation programs.”22 That result would be generally consistent with our advocacy which, as indicated, is to improve corporate governance practices at public companies on how decisions about stock buybacks are made to better ensure they are made with the long-term interests of investors in mind.

University of Massachusetts Amherst, Fellow, Roosevelt Institute at 7-10),
https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-palladinol-20191017.pdf (discussing how stock buybacks may create incentives for insiders to sell their own shares for personal gain).
15 See Statement of Lenore Palladino, Ph.D., J.D., Assistant Professor of Economics & Public Policy, University of Massachusetts Amherst, Fellow, Roosevelt Institute at 6-7 (discussing how stock buybacks may create the potential for stock price manipulation); Testimony of Derik Dwayne Coffey, CFA, Portfolio Specialist, Channing Capital Management, LLC at 4 (“Many of these gimmicks include using stock buybacks to reduce shares outstanding to inflate earnings per share growth or to increase Return on Equity, a popular shareholder return metric.”).
16 Testimony of Professor Jesse M. Fried, Dane Professor of Law, Harvard Law School at 1.
17 Joshua Bolton & Ken Bertsch.
18 See Council of Institutional Investors, CII Statement on Share Buybacks (“That is why CII advocates robust disclosure about the rationale for buybacks.”); see also Letter from Jeffrey P. Mahoney at 5 (“We also believe management should disclose how stock buybacks affect performance metrics, perhaps in a table showing how the company would have performed absent a change in the number of shares outstanding”).
20 Id. § 2(a)(1).
21 Id. § 2(a)(2).
22 Testimony of Professor Jesse M. Fried, Dane Professor of Law, Harvard Law School at 11.
In addition, we believe, consistent with the views of hearing witnesses Lenore Palladino and Mr. Fried, that the Improvement Act should be strengthened by including a provision requiring that buyback execution programs be more promptly disclosed. More specifically, we agree with Mr. Fried that Section 16(a) of the Securities Act of 1934 should be amended to require a public company “to disclose each trade in its own shares within two business days of the transaction.”

The basis for our proposed amendment to the Improvement Act was described by Mr. Fried in his testimony, in part, as follows:

Section 16(a) of the Securities Exchange Act of 1934 currently requires corporate insiders to provide detailed information about any trade in their firm’s shares within two business days. Firms trading in their own shares, by contrast, may wait months until they disclose the existence of trading activity in their own shares, and can get away with providing only aggregate data.

Share repurchases can provide certain benefits to public investors. However, executives can also use repurchases to transfer value from public investors to themselves, including through indirect insider trading. Tightening disclosure requirements by requiring repurchases to be individually disclosed within two days would go far in reducing executives’ abuse of repurchases, in a manner that does not interfere with the use of repurchases for benign purposes. Such detailed disclosure requirements would also enable Congress or the SEC to determine whether further steps are needed.

We believe the Improvement Act, with our proposed improvement, could assist investors in better understanding the relationship between stock buybacks, executive compensation, and capital allocation decisions.

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23 Statement of Lenore Palladino, Ph.D., J.D., Assistant Professor of Economics & Public Policy, University of Massachusetts Amherst, Fellow, Roosevelt Institute at 22 (“At minimum, Congress should immediately remove the ability of corporate insiders to personally benefit from buybacks and require their immediate disclosure.”).

24 Testimony of Professor Jesse M. Fried, Dane Professor of Law, Harvard Law School at 9-11, 14 (discussing, and expressing support for a proposed two-day disclosure rule).


26 Testimony of Professor Jesse M. Fried, Dane Professor of Law, Harvard Law School at 10.

27 Id. at 9, 14.
If we can answer any questions or provide additional information that would be helpful to you or the Subcommittee, please do not hesitate to contact me at 202.822.0800 or jeff@cii.org.

Sincerely,

Jeffrey P. Mahoney
General Counsel