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Does share buyback conceal a form of insider dealing reserved for corporate executives?

Op-Ed

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Until the end of the twentieth century, a company buying back its own shares was a criminal offense, in France as elsewhere. It has since become a legal and widespread practice among large corporations. The annual sums involved are staggering: 30 billion euros a year in France, 100 billion in Japan, and 1,000 billion in the United States. Some companies buy back as much as 3 to 5% of their capital every year, sometimes devoting more than half of their annual profit to it — to the detriment, some argue, of productive investment in research, production, or wages.

The official explanation is that these companies, pursuing short-term financial value creation, are betting on the accretive effect of such operations. A buyback at a low price, followed by a cancellation of the shares, does indeed reduce the total number of shares outstanding and mechanically boosts earnings per share, and therefore the price of the remaining shares. It is an appealing argument. Artificially propping up the share price is no longer seen as manipulation but as a "return to shareholders," or even as a defense against hostile takeover bids. Some studies even find that heavy buyers of their own shares systematically outperform their benchmark index.

In practice, however, repurchased shares are rarely cancelled. Most of the time they are either immediately replaced by new share issuances, or redistributed free of charge or at a reduced price (through stock options), as supplementary compensation, to employees and senior executives, with the aim of encouraging employee share ownership and executive commitment. Why? Because contemporary economic theory holds that the interests of shareholders and managers must be aligned by offering the latter free or discounted shares and/or preferential subscription or purchase option plans. As a result, these executives have become highly sensitive to the share price. Any rise in the share price triggers a "volume" effect, unlocking all or part of their variable pay, as well as a "price" effect, allowing them to realize capital gains on shares they already hold.

Because these executives know, ahead of the market — and legitimately so — when their company's share price is temporarily undervalued, and when the buyback program will be activated by their company, that timing itself becomes a piece of private information, one that can be easily and legally converted into gains by the very people who initiate the operation, to the detriment of the mass of buyers and sellers outside the company. Whether it concerns major contracts in the pipeline, innovations under development, workplace climate, the state of supply chains, or the outlook for ongoing operations that will shape upcoming quarterly results, the informational privilege of senior executives should not be underestimated.

An American study by Lenore M. Palladino of the University of Massachusetts Amherst (Roosevelt Institute, October 2019) put its finger on the issue, under the title "Do Corporate Executives Use Stock Buybacks for Personal Gain?" Examining data from listed non-financial companies from 2005 to 2017, the study finds that net insider sales of more than $100,000 are more than twice as frequent in quarters when share buybacks occur than in quarters without buybacks. Our hypothesis is that share buybacks, because they essentially amount to distributing bonuses to staff without weighing on reported results, in fact conceal a form of insider dealing reserved for executives. President Trump, an expert on the subject, moreover threatened on January 7 to ban such buybacks at defense companies that failed to comply with his demands.

What should be done? In both France and the United States, there appears to be virtually no prevention of these suspect transactions. The disclosure of executives' and their relatives' personal transactions does not coincide with the later disclosure of the company's own buyback programs. The "blackout" windows barring any trading for 30 days before annual and half-year results, and 15 days before quarterly results, are not enough. Senior executives remain free to buy or sell their shares before, and even during, the massive buybacks announced by their company. Worse still, the European Market Abuse Regulation (MAR), in force since 2016, shields issuers from any legal action for market manipulation or insider dealing as long as the program and its transactions are disclosed to the public and its objectives, conditions, timing, price, and volume of repurchased shares are complied with — in other words, mere procedural compliance.

If the aim is not to ban executives from trading their own shares while their company's buyback program is underway, as is the case in Japan, three measures could be considered. First, the MAR presumption of innocence should be reserved for any executive or manager responsible for buyback plans who holds company shares, directly or indirectly through relatives, in a dedicated custodial account (a blind trust).

Second, the holder of that account should agree that its management follow buy or sell instructions given once a year, on the same date, to a third-party operator and filed with the AMF; that operator should be barred from any communication with the account holder other than an after-the-fact report of the purchase or sale transactions carried out on their behalf. Finally, all purchase or sale transactions by internal insiders should be spread over eight consecutive trading days.

In addition, the Monetary and Financial Code should be amended to require the AMF to open an investigation whenever executives or other insiders buy or sell more than €100,000 worth of shares within 90 days before or after the launch of a buyback program. Likewise, any internal insider sale representing more than 0.1% of the volume of the buyback program should be considered suspect and subject to investigation.

It is time to reconcile finance with the economy, the economy with society, and society with the biosphere.

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