

STOCK BUYBACK ABILITY TO ENHANCE CEO COMPENSATION: THEORY, EVIDENCE, AND POLICY IMPLICATIONS

by
Nitzan Shilon*

I report that stock buyback ability to enhance CEO compensation has reached a record high amount corresponding to one-third of total pay. Also, I refute the common wisdom that this ability is attributed mainly to buyback impact on per share criteria that determine annual bonuses. Instead, I show that because of recent reforms in executive compensation design, the ability of buybacks to boost the amount of CEO stock-based compensation has become ten times higher than their potential to increase annual bonuses.

I argue, first, that the potential of stock buybacks to enhance their compensation provides CEOs with incentives to conduct buybacks excessively and opportunistically. Second, I explain that this ability motivates CEOs to game their incentive compensation arrangements and turn them from pay for performance into pay for manipulation. Third, I argue that firms camouflage the ability of stock buybacks to increase executive pay. Fourth, I explain that CEOs do not only have the incentives to abuse buybacks but they also have the power to act on these incentives, and that buyback activity is consistent with their incentives. Fifth, I argue that these distorted incentives are likely to lead firms to underinvest in productive capabilities, disguise poor financial performance, and contribute to the creation of a market bubble that increases the likelihood of another financial crisis. Borrowing from dividend protection, which safeguards executive stock and option awards from the automatic decline in the stock price that dividends trigger, I suggest applying buyback protection, which would shield executive pay from the mechanical performance improvement that stock buybacks stimulate. Because I do not expect a mandatory buyback

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protection rule to be effective, I propose making the impact of stock buybacks on executive pay transparent. Transparency can be expected to push boards, shareholders, and proxy advisors to pressure firms to adopt buyback protection.

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I. INTRODUCTION

We are living through a stock buyback revolution.¹ Over the last decade, the amount U.S. public firms have spent on buying back stock from their shareholders has risen threefold, to a record level of nearly \$1 trillion in each of the last two years.² Among the biggest repurchasers currently are firms such as Apple, Wells Fargo, and Merck, with each spending tens of billions of dollars on buybacks annually.³ Buybacks have increased so much that they have surpassed dividends and become the principal way in which firms distribute cash to their shareholders.⁴ They have also

¹ See *The Repurchase Revolution*, ECONOMIST (Sept. 13, 2014), <https://www.economist.com/business/2014/09/12/the-repurchase-revolution>.

² See GOLDMAN SACHS, TOP OF MIND: BUYBACK REALITIES 14 (Allison Nathan ed., 2019), <https://www.goldmansachs.com/insights/pages/top-of-mind/buyback-realities/report.pdf> (indicating that in 2018, roughly \$1.1 trillion of repurchases were authorized, with about \$900 billion actually repurchased); see also Jesse Pound, *Goldman Has a Big Worry Heading into 2020 that Could Cause Market Turmoil*, CNBC (Dec. 16, 2019, 8:23 AM), <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, they would still reach \$710 billion).

³ See David I. Templeton, *Stock Buyback Boom in 2018*, SEEKING ALPHA (Mar. 27, 2019, 5:51 AM), <https://seekingalpha.com/article/4251227-stock-buyback-boom-in-2018>.

⁴ See RIC MARSHALL ET AL., MSCI INC., TAKING STOCK: SHARE BUYBACKS AND SHAREHOLDER VALUE 3, 7 (2018), <https://www.msci.com/documents/10199/ba01b4c4-683c-74ca-339e-f422df5d879e> (reporting that share buybacks have become the favored means for distributing cash to investors among large-cap S. companies, exceeding cash dividends every year since 1997 at 388 of the 610 companies (63.6%); over a 15-year period (ending December 2016), the sampled 610 MSCI USA constituents paid over \$3.86 trillion in cash dividends and repurchased just under \$5.19 trillion of their own shares).

pushed total shareholder payouts to a level equal to the full amount of corporate earnings.⁵

The great importance of this trend has sparked vibrant debate among regulators, politicians, firms, and investors on whether to limit stock buybacks. Former presidential candidate Hillary Clinton has called for a curb on buybacks to discourage a culture of “quarterly capitalism” and a façade of higher short-term stock prices,⁶ while business mogul Warren Buffett disagrees and justifies buybacks as a tool to benefit long-term shareholders by signaling undervaluation of a company’s stock.⁷ A group of senior Democratic senators, led by Charles Schumer and Bernie Sanders,⁸ has proposed a bill that would prohibit buybacks unless firms invest in

⁵ See Jesse M. Fried & Charles C.Y. Wang, *Are Buybacks Really Shortchanging Investment?*, HARV. BUS. REV., Mar.–Apr. 2018, at 88, 90 (reporting that the ratio of dividends and stock repurchases to net income is high, reaching 96% during the period 2007–2016); Robert Ayres & Michael Olenick, *Secular Stagnation (or Corporate Suicide?)* 3 (July 11, 2017) (working paper), http://www.shareholderforum.com/access/Library/20170711_Ayres-Olenick.pdf (“Nearly 60% of non-financial public companies in the US have bought their own shares since 2010. In the last reporting year (2015) share repurchases were \$520 billion, along with \$320 billion in dividends, adding up to \$885 billion, as compared to net income of \$847 billion.”); see also Heather Slavkin Corzo, *Petition for Rulemaking to Revise Rule 10b-18*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 18, 2019), <https://corpgov.law.harvard.edu/2019/07/18/petition-for-rulemaking-to-revise-rule-10b-18> (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).

⁶ See Myles Udland, *HILLARY: Corporate America Is Obsessed with ‘Quarterly Capitalism’—Here’s How I’d Change That*, BUS. INSIDER (Apr. 1, 2016, 4:55 PM), <https://www.businessinsider.com/hillary-clinton-quarterly-capitalism-2016-4>; Jonathan Allen, *Hillary Clinton to Call for More Transparency in Stock Buybacks*, REUTERS (July 23, 2015, 8:44 PM), <https://www.reuters.com/article/us-usa-election-clinton-speech/hillary-clinton-to-call-for-more-transparency-in-stock-buybacks-idUSKCN0PY0AY20150724>.

⁷ The undervaluation theory posits that firms announce stock buybacks for the purpose of credibly signaling to the market that firm value exceeds its current stock price. See, e.g., Utpal Bhattacharya & Stacey E. Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence*, 20 REV. FIN. 725, 725–26 (2016); F.H. Buckley, *When the Medium Is the Message: Corporate Buybacks as Signals*, 65 IND. L.J. 493, 496, 525–33 (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, 1266 (1991); Ranjan D’Mello & Pervin K. Shroff, *Equity Undervaluation and Decisions Related to Repurchase Tender Offers: An Empirical Investigation*, 55 J. FIN. 2399, 2400 (2000); Ahmet C. Kurt, *Managing EPS and Signaling Undervaluation As a Motivation for Repurchases: The Case of Accelerated Share Repurchases*, 17 REV. ACCT. & FIN. 453, 458 (2018); William J. McNally, *Open Market Stock Repurchase Signaling*, FIN. MGMT., Summer 1999, at 55, 57–58 (1999).

⁸ 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>; see also Press Release, Tammy Baldwin: U.S. Senator for Wisconsin,

their workers and communities first.⁹ Wall Street titan Lloyd Blankfein fiercely opposes this bill, arguing that permitting firms to undertake buybacks freely promotes efficient asset allocation by allowing reinvestment of the distributed money in higher-growth businesses that boost the economy.¹⁰ Republican Senator Marco Rubio's plan to tax stock buybacks might have a chilling effect on them,¹¹ and the SEC is considering imposing additional limitations on stock buybacks in its Section 10b-18 "safe harbor," which currently allows corporations to engage in open market buybacks with less scrutiny for possible market manipulation.¹² Against this backdrop, Goldman Sachs has warned that a significant decline in the demand for stock that buybacks create could trigger a market collapse.¹³

U.S. Senator Tammy Baldwin Introduces Legislation to Rein in Stock Buybacks and Give Workers a Seat at the Table (Mar. 22, 2018), <https://www.baldwin.senate.gov/press-releases/reward-work-act> ("Corporate profits should be shared with the workers who actually create value. It's just wrong for big corporations to pocket massive, permanent tax breaks and reward the wealth of top executives with more stock buybacks, while closing facilities and laying off workers."); Press Release, Elizabeth Warren: U.S. Senator for Massachusetts, Warren Introduces Accountable Capitalism Act (Aug. 15, 2018), <https://www.warren.senate.gov/newsroom/press-releases/warren-introduces-accountable-capitalism-act> (explaining that the bill aims to reverse the harmful trends over the last 30 years that have led to record corporate profits that were returned to shareholders but resulted in stagnant salaries for workers).

⁹ See Schumer & Sanders, *supra* note 8. Such minimum requirements for corporate investment in employees include things like paying all workers at least \$15 an hour, providing seven days of paid sick leave, and offering decent pensions and more reliable health benefits. *Id.*

¹⁰ See Jesse M. Fried & Charles C.Y. Wang, *Short-Termism and Capital Flows*, 8 REV. CORP. FIN. STUD. 207, 210 (2019); see also, e.g., Liz Moyer, *Bernie Sanders and Lloyd Blankfein Get in Twitter Fight over Stock Buybacks*, CNBC (Feb. 5, 2019, 11:28 AM), <https://www.cnn.com/2019/02/05/blankfein-hits-back-at-senators-over-stock-buybacks-the-money-doesnt-vanish.html>.

¹¹ See U.S. Republican Senator Rubio Pushes Plan to Tax Stock Buybacks, REUTERS (Feb. 13, 2019, 2:06 PM), <https://www.reuters.com/article/us-usa-tax-buybacks/us-republican-senator-rubio-pushes-plan-to-tax-stock-buybacks-idUSKCN1Q22WY>.

¹² See Robert J. Jackson Jr., *Speech: Stock Buybacks and Corporate Cashouts*, SEC (June 11, 2018), <https://www.sec.gov/news/speech/speech-jackson-061118>; see also Hazel Bradford, *New Research Warrants Revisiting SEC Stock Buyback Rules, Commissioner Says*, PENSIONS & INV. (Mar. 6, 2019, 12:00 AM), <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 STREET J. (June 10, 2018, 12:00 PM), <https://www.wsj.com/articles/insiders-pocket-gains-on-buybacks-vexing-regulator-1528646400>.

¹³ See Theron Mohamed, *Goldman Sachs Sees Stock Buybacks Diving 15% This Year—and Warns Equities Could Suffer if the Trend Gains Steam*, BUS. INSIDER (Dec. 16, 2019, 11:12 AM), <https://www.businessinsider.sg/goldman-sachs-warns-drop-stock-buybacks-threatens-equity-prices-2019-12/>; Steven Pearlstein, *Beware the "Mother of All Credit Bubbles"*, WASH. POST (June 8, 2018, 9:32 AM), <https://www.washingtonpost.com/business/economy/beware-the-mother-of->

I do not take a side in the debate on whether to limit stock buybacks. I argue, however, that in order to let market forces work effectively without intervention, we should make sure that executive incentives to undertake buybacks are aligned with value creation. I show in this Article that the ability of stock buybacks to increase executive compensation motivates managers to act in ways that are not consistent with maximizing firm value, and I offer a remedy.

The distortion in incentives originates in the appreciable ability of stock buybacks to give executives an immediate head start in meeting common performance yardsticks that determine their incentive compensation, even if they do not make the firm financially stronger or increase firm value. Financial economists have long understood that by reducing the number of shares outstanding, buybacks mechanically improve earnings per share (EPS) and other per share performance criteria, which might enhance executives' annual bonuses. I show that higher EPS not only increases executives' bonuses but also enhances their long-term incentive awards. A higher EPS increases long-term awards because (i) EPS is the second most common performance criteria that determines long-term incentive awards; and (ii) a higher EPS pushes up total shareholder return (TSR), which is the most popular performance criteria that determines long-term awards. Higher EPS improves TSR because it helps firms satisfy analyst expectations, in turn creating higher demand for the company's shares. Moreover, buybacks increase the stock price and TSR, even if only temporarily, by creating greater demand for a company's own stock while decreasing the supply of its outstanding shares.¹⁴

My study of all executive compensation arrangements for CEOs included in the S&P 500 Index reveals that the potential of buybacks to pump up long-term incentive awards has dramatically increased, and that it is currently 10 times higher than the thoroughly-researched ability of buybacks to affect annual bonuses. Consequently, stock buybacks' ability to inflate executive pay through a mechanical improvement of performance measures that determine executive pay is higher than ever before. While in the mid-2000s buybacks could immediately improve measures responsible for an average of only 5% of CEO pay, today buybacks can enhance performance yardsticks responsible for an all-time high amount, averaging one-third of CEO pay, or almost \$4 million per CEO.¹⁵ I also find that the ability of buybacks to increase CEO pay varies greatly across firms.

My findings are troubling for three reasons. First, they indicate that corporate executives are motivated to conduct buybacks excessively. When buybacks are used excessively, they not only enrich the top 1% unjustifiably, but they also lead firms

all-credit-bubbles/2018/06/08/940f467c-69af-11e8-9e38-24e693b38637_story.html.

¹⁴ See *infra* Part II.

¹⁵ See *infra* Table III.

to underinvest in long-term productive capabilities and to avoid innovation, a phenomenon that *Forbes* has labeled “a cancer on capitalism.”¹⁶ Moreover, excessive buybacks can disguise poor business performance and undermine well-intended managers’ ability to signal undervaluation of their company stock. Excessive buyback incentives can also subvert the purpose of tax cuts and might have led corporate leaders to spend much of the \$1.5 trillion tax windfall they received from the 2017 Tax Cuts and Jobs Act on stock buybacks rather than investing it and creating jobs. Finally, excessive buybacks can addict markets to the artificial excess demand that they create and propel a stock market bubble that can burst into a financial crisis when firms can no longer provide markets with this “corporate cocaine.”¹⁷

Second, I argue that executives are motivated to use buybacks opportunistically in order to game their incentive compensation arrangements. That is possible when executives possess enough information to engineer a buyback that would allow them to just hit their performance targets. Existing literature already confirms that firms respond to this incentive by increasing their buyback activity when, absent the buyback, they would just miss their EPS forecast. Take, for example, Bruce Broussard, CEO of health insurer Humana, and Ursula Burns, former CEO of print and digital document producer Xerox. Humana repurchased shares valued at \$730 million, which added around three cents to the company’s annual EPS.¹⁸ This allowed Mr. Broussard to surpass his \$7.50 EPS target by a single cent.¹⁹ Despite Humana’s deteriorating performance and net income, the buyback secured a \$1.68 million bonus for Mr. Broussard and increased performance pay for Humana’s other top executives.²⁰ Similarly, Ms. Burns managed to exactly hit her \$1.12 EPS target—but only because Xerox spent \$1.1 billion on share buybacks.²¹ Because her annual bonus was predicated on hitting that EPS level, the buyback allowed Ms. Burns to

¹⁶ See Steve Denning, *U.S. Senators Challenge the S.E.C. on Share Buybacks*, FORBES (July 8, 2018, 6:06 PM), <https://www.forbes.com/sites/stevedenning/2018/07/08/u-s-senators-challenge-the-s-e-c-on-share-buybacks/#76f0fa438f8f>.

¹⁷ *Id.* (indicating that *The Economist* called stock buybacks “an addiction to corporate cocaine”; *Reuters* called it “self-cannibalization”; *The Financial Times* called it “an overwhelming conflict of interest”; and Professor William Lazonick called it “in effect, stock price manipulation”).

¹⁸ See Humana Inc., Annual Report (Form 10-K) 112 (Feb. 18, 2015), <https://humana.gcs-web.com/static-files/d9d274e6-bbe8-413d-bc20-6de43e41477e>.

¹⁹ See Humana Inc., Proxy Statement (Form DEF 14A) 41–42 (Mar. 6, 2015), <https://www.sec.gov/Archives/edgar/data/49071/000119312515079975/d851627ddef14a.htm>.

²⁰ *Id.* at 41; see Humana Inc., Annual Report, *supra* note 18, at 38 (showing decline in net income).

²¹ See Xerox Corp., Proxy Statement (Form DEF 14A) 37 (Apr. 6, 2015), https://www.sec.gov/Archives/edgar/data/108772/000114544315000520/xerox_def14a.htm; Xerox Corp., Annual Report (Form 10-K) 27 (Feb. 24, 2015), <https://investors.xerox.com/static-files/1de2a2f9-9a34-499e-b7f4-67f41b329ffc>.

receive a bonus of \$1.98 million.²² It also unlocked an even bigger pay increase for her in long-term incentive awards.²³

The ability to manipulate the financial criteria that determine incentive pay and to produce faked performance opportunistically circumvents *pay for performance* arrangements and turns them into *pay for manipulation*. The opportunistic façade of improved performance fails the very purpose of adding performance hurdles as a precondition to awarding incentive compensation. Such hurdles were added in response to the 2008 financial crisis in order to prevent what President Obama called “shameful” awards for business failures.²⁴

Third, I explain that firms camouflage the ability of stock buybacks to increase executive pay. In particular, firms commonly do not disclose that buybacks mechanically improve many performance criteria that decide executive pay. Moreover, firms rarely disclose if they exclude the impact of repurchases on these measures. The lack of transparency is so complete that even diligent and dedicated investors who succeed in evaluating the mechanical impact of buybacks on each performance measure often cannot identify the amounts that executives have actually received as a result.

These flawed incentives and camouflage are especially disturbing because executives have considerable power to force their buyback preferences on the firms they run. This power is created due to weak shareholder power, executive prerogative to decide buyback executions, and the common interest that executives and board directors have to use buybacks to boost the short-term stock price, which improves the unloading conditions for their equity compensation.

My empirical inquiry confirms that buyback activity is consistent with CEO interests. In particular, I find a very high correlation between the increase in buyback activity over the last two decades and the growing ability of buybacks to lift executive compensation. Furthermore, I find that stock buybacks tend to be higher in firms where the CEO can use a buyback to further increase her pay.

To remedy the flaws I uncover and to better align buyback decisions with value creation, I propose to exclude the mechanical impact of buybacks on executive compensation. Borrowing from dividend protection, which safeguards executive stock and option awards from the automatic decline in the stock price that dividends trigger, I suggest applying buyback protection. A buyback protection rule would shield the performance measures that decide executive pay from the impact of net stock buybacks, comprised of buybacks minus new stock issuances.

While buyback protection would exclude the mechanical and undue impact of repurchases on the performance criteria that determine executive pay, it would not

²² See Xerox Corp., Proxy Statement, *supra* note 21, at 51.

²³ *Id.* at 36, 51.

²⁴ See *President Obama's Remarks on Executive Pay*, N.Y. TIMES (Feb. 4, 2009), <https://www.nytimes.com/2009/02/04/us/politics/04text-obama.html>.

prevent well-intended firms that wish to encourage desirable buybacks from explicitly rewarding executives for doing so. For example, buyback protection would not prevent firms from remunerating their executives for achieving certain buyback goals that can be added as performance measures. Such rewards would avoid the flaws I describe in this Article.

While avoiding the mechanical improvement of performance criteria that decide executive pay, a buyback protection would not prevent firms from providing their executives with incentives to conduct desirable buybacks. In particular, firms that wish to encourage their executives to distribute free cash flows would be able to reward their executives for attaining certain buyback execution goals. According to Professor Michael Jensen, this would counter the incentives that corporate managers have to grow their firms beyond their optimal size in order to increase their power and compensation.²⁵

Because firms could circumvent a mandatory buyback protection rule by adjusting performance targets *ex ante*, I propose a regulatory reform that would make the impact of stock buybacks on executive pay transparent. 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.²⁶ I offer specific qualitative measures to gauge the potential of buybacks to mechanically improve performance measures as well as quantitative measures of the actual increase in executive compensation that buybacks have already triggered. I stress that firms should be required to conspicuously disclose whether they apply buyback protection, and if they do not, they should provide a clear explanation why they did not find it necessary.

More research should be done to identify the corporate governance failure that has created the incentives I uncover in this Article and to recommend a possible change to the allocation of power among boards of directors, executive officers, and shareholders with regard to stock buybacks. Because the distortion in buyback incentives I analyze serves the interests of both corporate executives and activist short-term investors, a corporate governance investigation should diverge from the traditional debate on the appropriate allocation of corporate decision-making power between managers and investors.

Before proceeding, I would like to emphasize that the systematic incentives I

²⁵ See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, AM. ECON. REV., May 1986, at 323, 323–24; Tom Nohel & Vefa Tarhan, *Share Repurchases and Firm Performance: New Evidence on the Agency Costs of Free Cash Flow*, 49 J. FIN. ECON. 187, 188 (1998).

²⁶ 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 (2020).

uncover to use buybacks excessively and opportunistically may not be the sole or predominant managerial motivation to conduct stock buybacks. For example, because they are able to mechanically improve a firm's stock price and perceived performance, corporate executives can be motivated to conduct buybacks to improve the conditions for cashing the stock and option awards that they receive as compensation,²⁷ to improve their short-term reputation, to appease shareholders, and to satisfy analyst expectations.²⁸

This Article is developed in four Parts. First, I present data describing the stock buyback boom and discuss existing theories that attempt to explain why firms conduct stock buybacks. Second, I explain in-depth how buybacks can be used to mechanically improve performance measures that decide executive pay. I also present my study of current executive compensation arrangements in S&P 500 firms, indicating that the potential to use buybacks to increase CEO pay is significant. Third, I explain why the ability of buybacks to enhance executive pay even when that would not increase firm value is troubling. I show that this ability motivates executives to undertake buybacks excessively and opportunistically and that such incentives are camouflaged in firms' public filings. In the fourth Part, I put forward my proposal to fix these flaws by making executive pay buyback-protected and argue that improving transparency would push firms to adopt it. The fifth Part presents my conclusion.

II. THE STOCK BUYBACK BOOM AND EXISTING EXPLANATIONS

A. The Stock Buyback Boom

The stock buyback boom has developed gradually. Despite the promulgation of SEC Rule 10b-18 in 1982, which provided firms engaging in stock buybacks a "safe harbor" against charges of market manipulation, until the mid-1990s stock buybacks were uncommon.²⁹ Instead, dividends were the main method used by corporate America to distribute cash to shareholders. Dividend payments from 1982 to 1997 were, on average, more than double the amount firms spent on stock buybacks (Figure I).

From the mid-1990s through the mid-2000s, stock buybacks emerged as an economically significant phenomenon, with firms allocating roughly the same

²⁷ See Robert J. Jackson, Jr., *Stock Buyouts and Corporate Cashouts*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 13, 2018), <https://corpgov.law.harvard.edu/2018/06/13/stock-buyouts-and-corporate-cashouts/>.

²⁸ See Heitor Almeida et al., *The Real Effects of Share Repurchases*, 119 J. FIN. ECON. 168, 169 (2016) (arguing that managers are willing to trade off investments and employment in favor of stock repurchases that allow them to meet analyst EPS forecasts).

²⁹ Ayres & Olenick, *supra* note 5, at 7–8; see *infra* Figure I.

amount of resources for buybacks that they set aside for dividends.³⁰ Yet it was not until the mid-2000s that stock repurchases surpassed dividends in importance. During the buyback boom between 2005 and 2019, the total amount S&P 500 firms spent on repurchases was almost 45% higher than the amount distributed as dividends.³¹ In 2018 and 2019, stock buybacks surged to a new record of roughly 85% and 65% higher than dividends, respectively.³²

Notably, buybacks increased more than dividends despite a steady and robust increase in dividend payouts. In fact, since 2005 firms have increased their dividends annually by an average rate of 6%.³³ Consequently, total shareholder distributions, counting stock buybacks and dividends together, have recently hit an all-time high amount that is roughly equal to total corporate earnings.³⁴

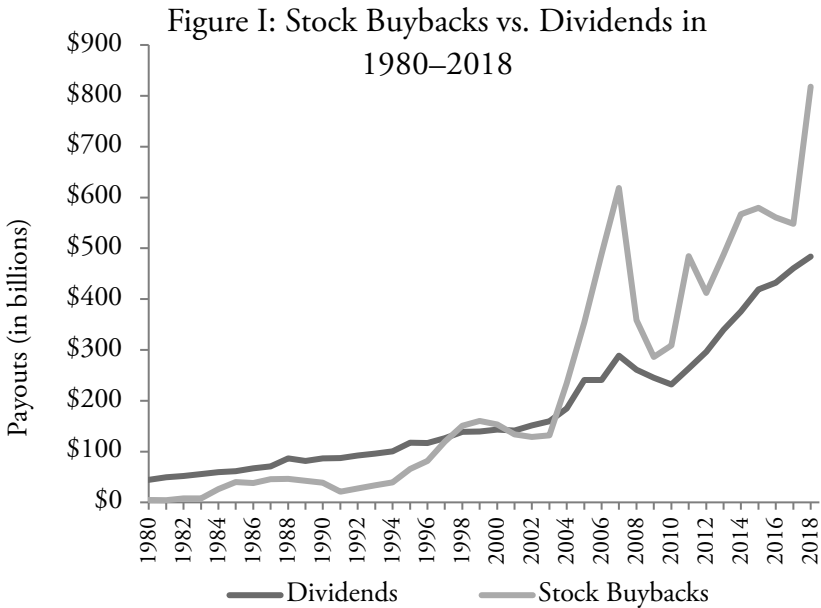
³⁰ See LIYU ZENG & PRISCILLA LUK, S&P GLOBAL, EXAMINING SHARE REPURCHASING AND THE S&P BUYBACK INDICES IN THE U.S. 2 (Mar. 2020), [markethttps://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf](https://www.spglobal.com/spdji/en/documents/research/research-sp-examining-share-repurchases-and-the-sp-buyback-indices.pdf).

³¹ See Compustat Database, <http://www.compustat.com> (downloaded Oct. 16, 2019) (showing that S&P 500 firms spent \$6.59 trillion on buybacks in 2015–2018 while distributing only \$4.57 trillion in dividends); see also Matt Krantz, *Half a Trillion Dollars Could Be Yours if You Own These Stocks*, INVESTOR'S BUS. DAILY (Jan. 8, 2020), <https://www.investors.com/etfs-and-funds/sectors/sp500-half-trillion-dollars-up-grabs-own-these-stocks-dividends/> (reporting that S&P 500 companies paid \$485.4 billion in dividends in 2019); Larry Light, *Share Buybacks to Slide 15% in 2019 and 5% Next Year, Says Goldman*, CHIEF INVESTMENT OFFICER (Dec. 18, 2019), <https://www.ai-cio.com/news/share-buybacks-slide-15-2019-5-next-year-says-goldman/> (reporting that buybacks of S&P 500 firms in 2019 totaled a staggering \$710 billion).

³² For 2018, see Compustat Database, *supra* note 31 (reporting that S&P 500 firms spent \$806 billion on buybacks in 2018 while distributing only \$434 billion in dividends). For 2019, see Krantz, *supra* note 31.

³³ See Compustat Database, *supra* note 31.

³⁴ See Fried & Wang, *supra* note 5, at 90; Ayres & Olenick, *supra* note 5, at 8; Corzo, *supra* note 5.



Source: Compustat.

Sample: All firms included in the S&P 500 Index.

B. Existing Explanations

A wide range of theories attempt to explain the dramatic increase in stock buybacks. Below I briefly examine five explanations widely cited in the academic literature and in the financial media. Three of these non-mutually exclusive theories focus on financial matters, one on agency theory, and another on tax considerations.

1. Financial Explanations

Business leaders such as Warren Buffett and Charlie Munger posit that firms whose shares are underpriced use repurchases as a value correction signal.³⁵ According to this theory, firms announce stock buybacks to convey to the market that their firm's value exceeds its current stock price. This signal, in turn, should lead to an

³⁵ For the position of Warren Buffett and Charlie Munger, see Charles Rotblut, *Buffett on Buybacks: Why Price Matters*, FORBES (Mar. 2, 2012, 10:33 AM), <https://www.forbes.com/sites/investor/2012/03/02/buffett-on-buybacks-why-price-matters/#1c80a0d55e47> (citing Warren Buffett's letter to Berkshire Hathaway's shareholders). For academic studies supporting this theory, see, for example, Bhattacharya & Jacobsen, *supra* note 7, at 725–26; D'Mello & Shroff, *supra* note 7, at 2400; Kurt, *supra* note 7, at 458; McNally, *supra* note 7, at 57–58.

increase in the stock price,³⁶ thereby benefitting long-term shareholders. Accordingly, 80% of managers report “stock price is too low” as a motivation for announcing a buyback.³⁷

A second attempt to explain the prevalence of stock buybacks focuses on their flexibility. Unlike dividends, buybacks are perceived by the financial markets as a one-time return of cash with no commitment to continue in future periods.³⁸ This ability to distribute excess cash to shareholders even if firms are unsure about their ability to repeat it in the future facilitates more efficient asset allocation within the firm as well as in the economy overall. Within the firm, more value is created when surplus cash that carries minimal interest is distributed to shareholders, who can reinvest it elsewhere for higher rates of return.³⁹ In turn, it is argued, the reinvestment process improves asset allocation in the economy by moving funds to firms with better investment opportunities.

A third financial explanation for buybacks posits that buybacks, unlike dividends, enable firms to counter dilution caused by employee stock option plans.⁴⁰ Option exercises increase the number of shares outstanding, thereby diluting the holdings of all other shareholders and reducing per share financial ratios such as EPS. Because a repurchase decreases the number of shares, it offsets the dilution that occurs when ordinary employees and corporate executives exercise their stock option awards.

2. Agency Theory Explanation

Professor Michael Jensen introduced in the 1980s the theory of agency costs of free cash flows, and argues that shareholder distributions, including stock buybacks, can reduce these costs.⁴¹ Jensen argues that corporate managers have incentives to cause their firms to grow beyond the optimal size and to keep cash flow in excess of that required to fund all value-increasing projects.⁴² Expanding the resources under

³⁶ Indeed, buyback announcements are associated with share price increases of approximately 2%. See Craig Lewis, *Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities and Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 22, 2019), <https://corpgov.law.harvard.edu/2019/10/22/examining-corporate-priorities-the-impact-of-stock-buybacks-on-workers-communities-and-investors-2/>.

³⁷ See Alberto Manconi et al., *Are Buybacks Good for Long-Term Shareholder Value? Evidence from Buybacks Around the World*, 54 J. FIN. & QUANTITATIVE ANALYSIS 1899, 1901 (2019).

³⁸ See RICHARD BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 405–19 (11th ed. 2013).

³⁹ See, e.g., Fried & Wang, *supra* note 10, at 229–30; Moyer, *supra* note 10.

⁴⁰ See, e.g., Daniel A. Bens et al., *Real Investment Implications of Employee Stock Option Exercises*, 40 J. ACCT. RES. 359, 360 (2002); Kathleen M. Kahle, *When a Buyback Isn't a Buyback: Open Market Repurchases and Employee Options*, 63 J. FIN. ECON. 235, 238 (2002).

⁴¹ See Jensen, *supra* note 25, at 323–24.

⁴² See *id.* at 323.

managers' control increases their power and compensation and reduces the monitoring power of capital markets in favor of internal financing.⁴³ Therefore, providing managers with incentives to undertake stock buybacks can reduce the agency costs of free cash flows because doing so motivates the managers to disgorge excess cash rather than diverting it to their own use, investing it at rates below the cost of capital, or wasting it on organizational inefficiencies.

3. Tax Explanation

Tax experts argue that firms use stock buybacks because of their unique tax benefits to shareholders. While dividends are taxed at ordinary tax rates, the gains that result from stock repurchases are taxed at lower capital gains rates.⁴⁴ Furthermore, most investors have to pay taxes on the cash they receive as dividends.⁴⁵ However, with a buyback, only those shareholders who choose to sell their stock back to the company have an immediate tax impact.⁴⁶

III. BUYBACKS CAN INCREASE EXECUTIVE COMPENSATION

I offer an alternative explanation for buybacks that focuses on executives' motivation to use them as a tool to increase their compensation. The ability of repurchases to unjustifiably enrich corporate managers recently received growing attention after SEC Commissioner Robert Jackson demonstrated that the immediate price pop that buybacks create improves the unloading conditions for managers' equity awards.⁴⁷ He also documented that corporate leaders take full advantage of this opportunity to cash in their equity awards at a higher price.⁴⁸ In particular, Jackson found that while in the days before a buyback announcement managers traded in relatively small amounts—less than \$100,000 worth—during the eight days following a buyback announcement they sell on average more than \$500,000 worth of stock each day, a fivefold increase.⁴⁹

Although financial economists have long analyzed the impact of stock buybacks on EPS,⁵⁰ no academic study has systematically analyzed the potential of buybacks

⁴³ See *id.*

⁴⁴ See, e.g., Gustavo Grullon & David L. Ikenberry, *What Do We Know About Stock Repurchases?*, J. APPLIED CORP. FIN., Spring 2000, at 31, 40.

⁴⁵ Trevir Nath, *4 Reasons Investors Like Buybacks*, INVESTOPEDIA (Updated July 20, 2020), <https://www.investopedia.com/articles/investing/123115/4-reasons-why-investors-buybacks.asp>.

⁴⁶ Grullon & Ikenberry, *supra* note 44, at 40.

⁴⁷ See Jackson, *supra* note 27. For an analysis explaining why such a price increase happens, see discussion in the next Section.

⁴⁸ See *id.*

⁴⁹ *Id.*

⁵⁰ See, e.g., Kurt, *supra* note 7, at 456.

to improve other executive pay performance measures. Moreover, no study thus far has quantified the resulting ability of stock buybacks to pump up executives' annual bonuses and long-term incentive awards. This study aims to fill this gap.

A. Buybacks Can Increase Executive Compensation: Theory

Stock buybacks can increase executive compensation even when they would not improve firm value. This happens when, in addition to the real economic impact they trigger, they mechanically improve the performance measures that determine executives' incentive compensation. When such measures are improved sufficiently, they allow the executive to reach a higher performance level and pocket higher bonuses and higher long-term incentive awards.

1. Improvement of Performance Measures

Stock buybacks improve common performance measures even when they might not increase firm value. This provides corporate executives with a head start in meeting the goals they should attain to receive their annual bonuses and long-term incentive awards. Such performance measures include EPS, other per share financial measures, and TSR.

As previous studies have indicated, by reducing the number of shares outstanding—the EPS denominator—buybacks mechanically increase EPS.⁵¹ This enables a company to increase this important ratio without actually increasing its earnings or doing anything to otherwise prove that it is becoming financially stronger. Take, for example, a company with earnings of \$100 and 100 outstanding shares, resulting with an EPS of \$1. If that company repurchases 5 shares it would immediately improve its EPS to \$1.05.⁵² A recent Goldman Sachs study reports that in the real world buybacks mechanically improve EPS significantly.⁵³ Over the past 15 years, EPS growth outpaced actual earnings growth by 2.6% due to stock buybacks.⁵⁴

⁵¹ EPS is defined as total earnings divided by the number of shares outstanding. For studies that recognized buyback ability to improve EPS, see, for example, Almeida et al., *supra* note 28, at 172–73; Bens et al., *supra* note 40, at 363.

⁵² Because the largest 500 public firms in the U.S. repurchased, on average, almost 3.7% of their market capitalization value in buybacks during 2018 alone, they reduced their number of shares and mechanically increased EPS by roughly the same ratio. See Martin Baccardax, *S&P 500 Returned a Record \$1.26 Trillion in 2018 as Buybacks Topped \$806 Billion*, THESTREET (Mar. 25, 2019, 11:19 AM), <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); *U.S. Top 500 Companies—Total Market Cap*, SIBLIS RES., <http://siblisresearch.com/data/total-market-cap-sp-500/> (last visited Mar. 3, 2021), (reporting that the total market capitalization of the S&P 500 Index was about \$22 trillion at the end of 2018).

⁵³ Light, *supra* note 31.

⁵⁴ *Id.*

Similar to their impact on EPS, by reducing the number of shares outstanding, buybacks mechanically improve other per share financial ratios that determine incentive compensation. These measures include return on invested capital (ROIC), return on assets (ROA), and return on equity (ROE).⁵⁵ The impact on such measures depends on the way in which the buyback is financed. When the buyback is financed entirely with new debt, the buyback is not expected to impact these ratios. Yet because repurchases are commonly not debt-financed,⁵⁶ they are nonetheless likely to improve all such per share measures.

Buyback ability to reduce the number of shares that determine EPS and other per share criteria decreases when it is executed towards the end of the measurement period. Generally accepted accounting principles (GAAP) provide that the number of shares used for EPS are the time-weighted average over the measurement period.⁵⁷ For example, if a firm buys back 1% of its shares outstanding only one month before the end of the year, the GAAP annual number of shares for EPS purposes will be reduced by only 1/12%. Although firms commonly adjust the GAAP rules for their EPS performance measures,⁵⁸ they do not seem to adjust this time-weighted feature.

Previous studies have failed to recognize that buybacks also improve TSR, calculated as the percentage of stock price appreciation plus dividend yield.⁵⁹ In theory, this is not supposed to happen. Because stock buybacks lever up the firm's capital structure, according to the Modigliani-Miller theorem they should increase the riskiness and the expected return of the stock.⁶⁰ That, in turn, should decrease the stock

⁵⁵ ROIC is a metric used to assess CEO success in allocating the firm's capital and is calculated as the ratio between the company's net operating profit after tax and the firm's invested capital. The return on assets ratio formula is calculated by dividing net income by average total assets. The return on equity ratio is a product of dividing net income by shareholder equity.

⁵⁶ See Gregory Calderone, *Debt-Financed Share Buybacks Dwindle to Lowest Level Since 2009*, BLOOMBERG (Jan. 27, 2019, 2:00 AM), <https://www.bloomberg.com/news/articles/2019-01-27/debt-financed-share-buybacks-dwindle-to-lowest-level-since-2009> (reporting that debt-financed buybacks fell to 14% of the total, the lowest since 2009).

⁵⁷ *Earnings Per Share*, FIN. ACCT. STANDARDS BD., <https://asc.fasb.org/section&trid=2144400#d3e1444-109256> (last visited Mar. 3, 2021).

⁵⁸ See, e.g., Tom Ramagnano & Michael Meyer, *When Using EPS in Incentive Plans, Take Time to Specify How It's Calculated*, NACD DIRECTORSHIP, Mar.–Apr. 2019, at 68, 68, https://www.meridiancp.com/wp-content/uploads/NACD-Directorship-MarchApril-2019_Director-Advisory_Meridian.pdf; Robert C. Pozen & S.P. Kothari, *Decoding CEO Pay*, BROOKINGS (June 21, 2017), <https://www.brookings.edu/research/decoding-ceo-pay/>.

⁵⁹ Many firms use a relative total shareholder return measure, which calculates total shareholder return compared with the company's peer group. *The Holy Grail: What LTI Measures Drive Corporate Performance?*, FIN. EXECUTIVES INT'L (June 4, 2015), <https://daily.financialexecutives.org/the-holy-grail-what-lti-measures-drive-corporate-performance/>.

⁶⁰ See Anne P. Villamil, *Modigliani-Miller Theorem*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS (2d ed. 2008).

price.

Nonetheless, two powerful manipulative forces enable buybacks to raise the stock price and TSR, even if temporarily. First, companies use buybacks to intervene in the operation of free markets by increasing the demand for companies' shares and decreasing the supply. Under SEC Rule 10b-18, an issuer's total repurchases on any single day must not exceed 25% of its four-week average daily trading volume.⁶¹ Nevertheless, an artificial boost in demand amounting to a quarter of trading volume can significantly change a stock price equilibrium. This is especially true because, due to lax disclosure rules, market participants cannot tell on any given day if the increased demand comes from the issuer's buybacks or from disinterested parties.⁶²

A recent Goldman Sachs report indicates that the interference of buybacks in stock markets successfully supports higher equity prices and TSR.⁶³ Strikingly, since 2011 buybacks have been the single biggest source of U.S. equity demand.⁶⁴ The firm reports that this has dramatically shifted the supply-demand curve for the stock of companies that buy back shares.

Second, because buybacks mechanically improve EPS, and because this helps firms satisfy analyst expectations and support their buy recommendations with regard to company stock,⁶⁵ the buyback should increase the demand for the stock regardless of the impact on its intrinsic value. The expectation for such a demand increase should be factored into sophisticated investors' stock trades and consequently self-fulfill the price improvement prophecy that buybacks deliver. Consistent with this prediction, a recent academic study documented abnormal returns of more than 2.5% in the 30 days following buyback announcements.⁶⁶

⁶¹ 17 C.F.R. § 240.10b-18(b)(4) (2020).

⁶² Firms are not required to report stock buyback executions until the next quarterly filing, and even then they are required to report only monthly aggregate amounts. Purchases of Equity Securities by the Issuer and Affiliated Purchasers, 17 C.F.R. § 229.703 (2020); U.S. SEC. EXCH. COMM., FORM 10-Q: GENERAL INSTRUCTIONS 6 (2019).

⁶³ See Chris Matthews, *Buybacks Are the 'Dominant' Source of Stock-Market Demand, and They Are Fading Fast: Goldman Sachs*, MARKETWATCH (Nov. 9, 2019, 11:48 AM), <https://www.marketwatch.com/story/buybacks-are-the-dominant-source-of-stock-market-demand-and-they-are-fading-fast-goldman-sachs-2019-11-06>.

⁶⁴ Mohamed, *supra* note 13.

⁶⁵ Some commentators argue that a buyback boosts the stock price because it mechanically increases EPS, and if the price-to-earnings (P/E) ratio stays constant, it must boost the price. Other commentators doubt this mechanism. See Obi Ezekoye et al., *How Share Repurchases Boost Earnings Without Improving Returns*, MCKINSEY & CO. (Apr. 29, 2016), <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-share-repurchases-boost-earnings-without-improving-returns>.

⁶⁶ See Jackson, *supra* note 27. This finding is consistent with the longstanding finance literature on the effect of stock buyback announcements on near-term stock prices. See, e.g., Jesse

In theory, the short-term improvement that buybacks trigger on executives' performance measures should dissipate. In the long term, the cash outlay that buybacks impose should reduce earnings and decrease EPS. Also, the stock price and the elevated TSR should bounce back after the stock trades clear from the excess demand and shortage in supply that a buyback triggers. Moreover, if the buyback reduces the firm's intrinsic value, the forgone value should eventually reduce earnings and be factored in the price, if markets are efficient.

However, in reality firms manage to prolong the buyback impact on executives' performance measures. This happens when firms repeat buybacks continuously, thereby keeping a long-term asymmetry between earnings and EPS. Moreover, the expectation for continuous buybacks keeps TSR high for prolonged periods as traders rely on firms' ability to maintain their improved performance mechanically.

2. Improved Performance Measures Lead to Higher Incentive Payouts

When buybacks improve executive performance measures, they are likely to increase incentive awards, since firms award higher bonuses and higher equity awards for achieving better performance marks. The vast majority of firms grant incentive awards for attaining one of three predetermined performance levels: threshold, target, and maximum, and double the award when the executive successfully moves from one performance level to another.⁶⁷ For example, a company may decide that the CEO's bonus should be predicated on achieving certain EPS measures and that the CEO would not be eligible for a bonus for any EPS mark below 50 cents (the threshold level). If the company attains an EPS between 50 cents and \$1 (the target level), the CEO would receive a \$1 million bonus, and if the EPS is between \$1 and \$2 (the maximum level), the CEO would pocket a \$2 million bonus. If the EPS is above \$2, the CEO's bonus would be \$4 million.

3. Firms Do Not Adjust Performance Goals to Account for Buybacks

Firms could exclude the mechanical impact of stock buybacks on executive pay by accounting for the effect of share repurchases on the financial metrics used for determining annual bonuses and long-term performance awards. As I propose in the last Section, this could be done either by adjusting performance goals *ex post* or by adjusting these criteria *ex ante* to reflect an expected buyback.

Unfortunately, however, firms rarely disclose that they adjust performance goals to account for stock buybacks. In fact, only 20 firms included in the S&P 500

M. Fried, *Insider Signaling and Insider Trading with Repurchase Tender Offers*, 67 U. CHI. L. REV. 421, 444 (2000); David Ikenberry et al., *Market Underreaction to Open Market Share Repurchases*, 39 J. FIN. ECON. 181, 190 (1995).

⁶⁷ See COMPENSATION ADVISORY PARTNERS, INDUSTRY REPORT 2017–2018: CAP 100 COMPANY RESEARCH 3, <https://www.capartners.com/wp-content/uploads/2017/01/CAP-Report-2017-2018-100-Co-Research.pdf>.

Index have disclosed that they have such policies.⁶⁸ These firms include FedEx,⁶⁹ GameStop,⁷⁰ and Johnson & Johnson.⁷¹ Some other firms, such as Home Depot⁷² and Qualcomm,⁷³ disclosed such policies in the past but no longer reveal that they have them.

Some firms not only abstain from disclosing policies that adjust performance goals to buybacks but also publicly state that they intentionally refrain from doing so. One of these firms is the multinational conglomerate 3M.⁷⁴ The performance goals for \$4.7 million in incentives for Chairman, CEO, and President Inge Thulin include EPS growth.⁷⁵ Because buybacks can mechanically improve this measure, a detailed shareholder proposal urged the company to adopt a policy that will account for them.⁷⁶ Unfortunately, the company has summarily dismissed this shareholder proposal, stating:

[T]he 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.⁷⁷

Firms commonly refrain from disclosing policies that exclude the mechanical *positive* impact of buybacks on executive compensation despite their common disclosure of their practice of accounting for the automatic *negative* influence of dividends on pay.⁷⁸ Dividends tend to reduce share price by the amount of the dividend

⁶⁸ Karen Brettell et al., *Stock Buybacks Enrich the Bosses Even when Business Sags*, REUTERS (Dec. 10, 2015, 5:00 PM), <https://www.reuters.com/investigates/special-report/usa-buybacks-pay/>.

⁶⁹ See FedEx Corp., Proxy Statement (Form DEF 14A) 47 (Aug. 13, 2018), <https://www.sec.gov/Archives/edgar/data/1048911/000120677418002406/fedex3330721-def14a.htm>.

⁷⁰ See GameStop Corp., Proxy Statement (Form DEF 14A) 24 (May 16, 2018), <https://www.sec.gov/Archives/edgar/data/1326380/000132638018000052/a2018defproxystatement.htm>.

⁷¹ See Johnson & Johnson, Proxy Statement (Form DEF 14A) 55 (Mar. 13, 2019), <https://www.sec.gov/Archives/edgar/data/200406/000020040619000013/a2019jnjproxy.htm>.

⁷² See Home Depot Corp., Proxy Statement (Form DEF 14A) 37 (May 19, 2016), <https://www.sec.gov/Archives/edgar/data/354950/000119312516529376/d24558ddef14a1.pdf>.

⁷³ See Qualcomm Inc., Proxy Statement (Form DEF 14A) 5 (Jan. 21, 2016), <https://www.sec.gov/Archives/edgar/data/804328/000123445216000341/proxy2016.htm>.

⁷⁴ 3M Co., Proxy Statement (Form DEF 14A) 78–79 (Mar. 23, 2016), https://www.sec.gov/Archives/edgar/data/66740/000120677416005067/threem_def14a.htm.

⁷⁵ *Id.*

⁷⁶ *Id.* at 78.

⁷⁷ *Id.*

⁷⁸ Alice Bonaimé et al., *Employee Compensation Still Impacts Payout Policy*, CRITICAL FIN. REV. (forthcoming 2020) (manuscript at 1–2), <https://papers.ssrn.com/sol3/papers.cfm?>

payment. Hence, without correcting for the stock price decline that dividends trigger they would reduce the value of executive compensation awards, such as stock options and restricted stock. In order to protect executive compensation, the vast majority of firms grant stock options and restricted stock with dividend protection.⁷⁹

B. Buybacks Can Increase Executive Compensation: Evidence

Sweeping changes in the composition of executive compensation over the last two decades have dramatically increased the ability of buybacks to pump up executives' long-term incentive awards. In particular, changes in accounting rules and corporate governance have significantly increased firms' usage of performance equity. The initial change occurred in 2006, when Financial Accounting Standard 123R revised the accounting standards for stock options.⁸⁰ Options now require an accounting expense, which has pushed firms to shift from granting options toward using stock grants.⁸¹ As a result of shareholder demand, companies started to condition the grant of many of these awards on achievement of certain performance goals over the measurement period.⁸²

The more recent changes have been influenced by the 2008 financial crisis. Coinciding with the passage of Dodd-Frank and the resultant implementation of mandatory votes on executive compensation (known as "Say on Pay"),⁸³ shareholders gained considerable power to impact companies' pay practices.⁸⁴ Institutional investors, aided by advisory firms such as ISS and Glass Lewis, have become more aggressive in their attempts to improve the alignment of CEO compensation with company performance.⁸⁵ They became less sympathetic to the argument that plans

abstract_id=3180292.

⁷⁹ Firms provide dividend protection by paying the executive accumulated dividends (plus interest) upon exercise of the underlying options. See Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2493 (Orley C. Ashenfelter & David Card eds., 1999). Firms provide dividend protection for stock awards by granting managers with additional stock in an amount equal to the accumulated dividends during their vesting period plus interest. See Bonaimé et al., *supra* note 78, at 9 (reporting that the vast majority (91%) of firms with restricted stock grant it with dividend protection).

⁸⁰ FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 123, at 1 (2004), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220128981.

⁸¹ *Id.* at 2–3.

⁸² See EQUILAR, CEO PAY TRENDS 2 (June 2017) (on file with author).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.* at 20.

that award stock with the passage of time are inherently performance-based,⁸⁶ and they pushed public firms harder to add performance hurdles as preconditions to awarding equity compensation.⁸⁷ Such performance-conditioned awards have rapidly become the most common vehicle by which long-term incentive compensation is delivered.⁸⁸ They now weigh an unprecedented 58% of the \$7.7 million that S&P 500 CEOs receive on average in such incentives.⁸⁹

1. Methodology

Because of the dramatic increase in the ability of buybacks to trigger higher long-term incentive awards for executives, and due to buybacks' recognized ability to inflate annual bonuses,⁹⁰ I hypothesize that repurchases can significantly boost executive compensation. To test this hypothesis, I surveyed all compensation arrangements of CEOs included in the S&P 500 Index. I focus on the CEO because she is typically the most powerful figure within the top executive team, capturing the highest pay slice and having the strongest impact on the value, performance, and behavior of a public firm.⁹¹

In order to quantify the portion of CEO pay that buybacks automatically improve, I considered annual bonuses and long-term incentive awards decided by EPS, TSR, ROIC, ROE, ROA, and other per share criteria. When an award was based on multiple criteria, I considered only the portion of the grant decided by criteria that buybacks improve, such as EPS and TSR.

I obtained data regarding CEO performance measures, including its weighting and target value, from the ISS Incentive Lab. Using Compustat, I collected information on stock buyback activity.⁹² When necessary, I pulled from companies' proxy statements missing data about the weights that each metric decides. When neither ISS Incentive Lab data nor companies' proxy statements indicate the portion

⁸⁶ See *id.*

⁸⁷ See *id.*

⁸⁸ See EQUILAR, CEO PAY TRENDS 15 (July 2019) (on file with author) (showing that 58% of long-term incentives at large companies were performance based as of 2018).

⁸⁹ *Id.* at 12, 15.

⁹⁰ *Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investment Before the Subcomm. on Inv. Protection, Entrepreneurship, and Cap. Mkts. of the H. Comm. on Fin. Servs.*, 116th Cong. 8–9 (2019) (statement of Jesse M. Fried, Dane Professor of Law, Harvard Law School), <https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-friedj-20191017.pdf>.

⁹¹ See Lucian A. Bebchuk et al., *CEO Centrality* 1–6 (Nat'l Bureau of Econ. Research, Working Paper No. 13701, 2007), <http://www.nber.org/papers/w13701> (discussing the centrality of the CEO within the top team of executives).

⁹² Following Banyl et al., I use the variable *purchases of common and preferred stock* (prstkc) to measure stock repurchase. Monica Banyl et al., *Measuring Share Repurchases* 11–12 (Aug. 2005) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=726284.

that each criterion determines in a specific grant, I assumed equal weighting for all metrics. Furthermore, because the ISS Incentive Lab does not distinguish among threshold, modifier, and baseline criteria, all were treated as if they were baseline measures, with equal weighting for each type of measure.

2. Findings

a. Buybacks' Increase of CEO Bonuses

I find that, on average, stock buybacks can automatically improve performance measures that are responsible for more than \$350,000, or almost 20%, of S&P 500 CEO annual bonuses (Table III). While buybacks cannot immediately increase the annual bonuses of just over half of CEOs, for most other CEOs buybacks mechanically improve measures that determine 10% to 60% of their bonuses (Figure II).

Buybacks increase CEO bonuses mostly through their mechanical improvement of EPS. This channel is significant for two reasons. First, EPS appears as a performance measure in most bonus plans. Second, when EPS is used to determine CEO bonuses it decides, on average, almost 40% of the bonus (Figure III), or nearly \$750,000 (Table I). Let's assume that this CEO's current EPS is \$0.98 while her EPS target is \$1. The CEO bonus would typically be reduced by half to only \$375,000 if she misses her EPS target. To meet her \$1 EPS target and double her bonus, the CEO could make her firm repurchase 2% of the company's outstanding shares.⁹³ This buyback could also improve other performance measures that decide the remainder of the CEO's incentive compensation, such as ROIC and TSR.

Bruce Broussard, CEO of health insurer Humana, and Ursula Burns, former CEO of printer and copier maker Xerox, were in a similar situation. Humana conducted a \$730 million share repurchase, which added around three cents to the company's annual EPS. This allowed Mr. Broussard to surpass his \$7.50 EPS target by a single cent.⁹⁴ Despite Humana's worse-than-expected 21% drop in net income, the buyback unlocked a \$1.68 million bonus for Mr. Broussard and increased performance pay for Humana's other top executives.⁹⁵ Similarly, Ms. Burns managed to hit her \$1.12 EPS target exactly, but only because Xerox conducted a \$1.1 billion stock buyback.⁹⁶ Because her annual bonus was predicated on hitting that EPS level, the buyback allowed Ms. Burns to receive a bonus of \$1.98 million.⁹⁷

⁹³ A repurchase of 2% of the shares would decrease the EPS denominator (number of shares outstanding) by 2%, thereby increasing EPS by the same ratio. In the short term, the repurchase would have no impact on total earnings, which determine the EPS numerator.

⁹⁴ Humana Inc., Annual Report (Form 10-K) 41 (Feb. 18, 2015), <https://www.sec.gov/Archives/edgar/data/49071/000004907115000019/hum-20141231x10k.htm>; Brettell et al., *supra* note 68.

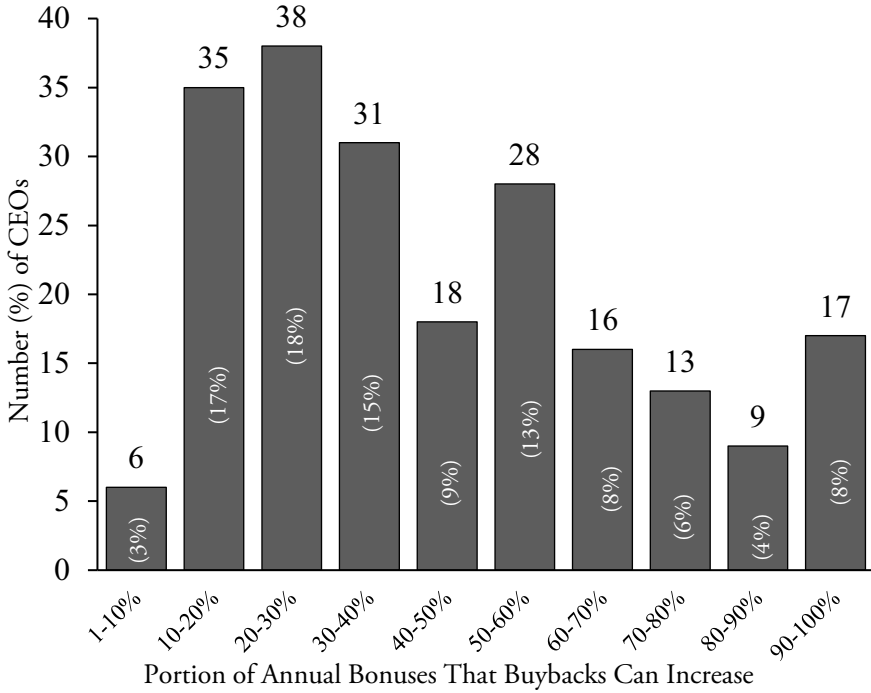
⁹⁵ See Brettell et al., *supra* note 68.

⁹⁶ *Id.*

⁹⁷ *Id.*

Mr. Broussard and Ms. Burns are not alone. A recent paper reports that 29% of firms with accelerated stock repurchase programs would have missed their consensus EPS forecasts had they not implemented a repurchase.⁹⁸ This suggests that managerial incentives to secure bonuses lie behind many repurchases.⁹⁹

FIGURE II: DISTRIBUTION OF BUYBACK POTENTIAL TO INCREASE ANNUAL BONUSES



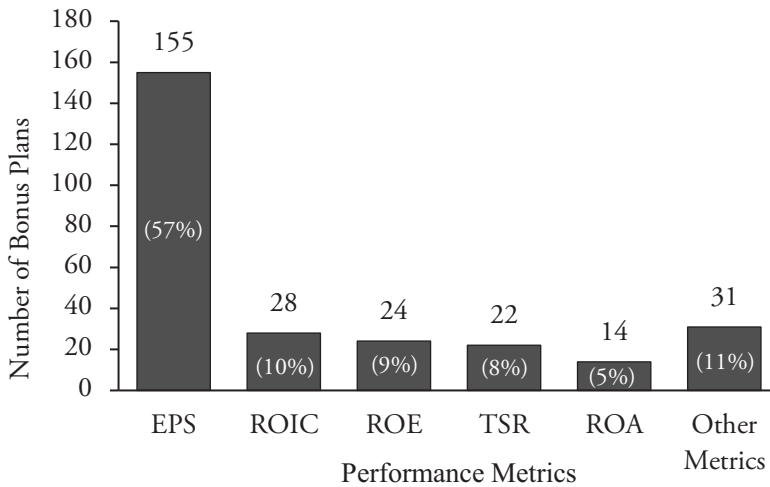
Source: ISS Incentive Lab.

Sample: Based on 211 CEOs included in the S&P 500 Index. Data as of Q4 2018.

⁹⁸ Kurt, *supra*, note 7, at 455.

⁹⁹ *See id.* at 457.

FIGURE III: BONUS PERFORMANCE MEASURES THAT BUYBACKS IMPROVE



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: BONUS PERFORMANCE DETERMINANTS THAT BUYBACKS INCREASE

<i>Performance Criterion</i>	<i>Number of Grants</i>	<i>Average Portion of Bonus That the Criterion Decides</i>	<i>Average \$ Value of Bonus That the Criterion Decides</i>
EPS	186	39%	742,365
ROE	29	34%	647,190
ROA	18	27%	506,333
TSR	26	25%	475,876
ROIC	30	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' Increase of CEO Long-Term Incentive Awards

I find that the amount of long-term incentive awards that buybacks automatically inflate is 10 times higher than their ability to increase annual bonuses. Overall, stock repurchases give CEOs a head start in meeting performance measures that decide, on average, more than \$3.72 million, or almost two-thirds, of S&P 500 CEO long-term incentive awards (Table III). The impact of buybacks on long-term

awards is so high that they increase the entire value of long-term grants for most CEOs.¹⁰⁰ For the remainder of CEOs, buybacks improve measures responsible for the majority of their long-term incentives (Figure IV).

Because buybacks improve performance measures that are responsible for an even higher portion of long-term incentive awards than for annual bonuses, the incentive to use them in order to inflate long-term awards is stronger. Similarly to bonus awards, long-term awards are predicated on achieving one of three performance levels: threshold, target, and maximum.¹⁰¹ Because buybacks immediately improve measures that determine an average of \$3.72 million in CEO long-term incentive awards,¹⁰² when they move the CEO from threshold to target performance, the manager would pocket, on average, an extra \$1.86 million. In other cases, buybacks can help a CEO move from target to maximum performance level and receive, on average, an extra \$3.72 million in long-term awards.¹⁰³

Buybacks' potential to increase CEO long-term awards comes primarily from their boost in TSR, a measure that appears in almost half of CEO long-term incentive plans (Figure V). When TSR is used, it is responsible for an average \$3.74 million in incentive awards.¹⁰⁴ An increase in EPS, which was the most important contributor to the effect of buybacks on CEO annual bonuses, is the second most significant determinant that allows buybacks to increase long-term incentive awards.¹⁰⁵ I find that EPS is used in nearly one-quarter of long-term incentive plans (Figure V). In such plans, EPS decides, on average, \$2.65 million, or almost one-half, of the award.¹⁰⁶

When executives use buybacks to improve EPS, they are likely to increase not only their bonuses but also their long-term incentive awards. A case in point is the gigantic buyback by Xerox described in the previous Section. The buyback, which allowed Xerox CEO Ursula Burns to exactly meet her \$1.12 EPS target, helped her secure a high bonus—and also unlocked an even bigger pay increase for her in long-term incentive awards in the following year.¹⁰⁷

Unlike the impact of buybacks on EPS, it is hard to predict the precise buyback

¹⁰⁰ When buybacks can increase substantially the entire value of CEO long-term awards, it is mostly due to its impact on TSR. Specifically, buybacks can increase at least 90% of the long-term awards of 195 CEOs. For this group, long-term awards are decided solely by TSR for 63 CEOs, and for another 121 CEOs, TSR determines at least half of their long-term incentive awards.

¹⁰¹ See COMPENSATION ADVISORY PARTNERS, *supra* note 67, at 3.

¹⁰² *Infra* Table III.

¹⁰³ See *infra* Table III; COMPENSATION ADVISORY PARTNERS, *supra* note 67, at 3.

¹⁰⁴ See *infra* Table II.

¹⁰⁵ See *infra* Table II.

¹⁰⁶ See *infra* Table II.

¹⁰⁷ See Brettell et al., *supra* note 68.

increase in TSR. Buybacks increase TSR through their impact on the stock price. Because the buyback impact on the stock price depends on the level of market efficiency, it is difficult to foresee the exact market response to a buyback. Therefore, it is hard for a CEO to gauge in advance the size of repurchase that would be sufficient to enable her to hit a desired TSR level.¹⁰⁸

Despite the difficulty of predicting the exact improvement in TSR that a buyback would trigger, the issue of using buybacks to hit TSR goals is real. Take Robert Kotick, CEO of the well-known video games and film company Activision Blizzard. He received a \$56 million grant of performance-based cash and stock awards scheduled to vest over three years, depending in part on the company's TSR.¹⁰⁹ Of that three-year grant, Kotick received awards valued at \$22 million in a single year because he met his TSR goal.¹¹⁰ What helped him achieve this target was an \$8.2 billion share repurchase the company conducted as part of a deal in which Kotick had a personal interest.¹¹¹

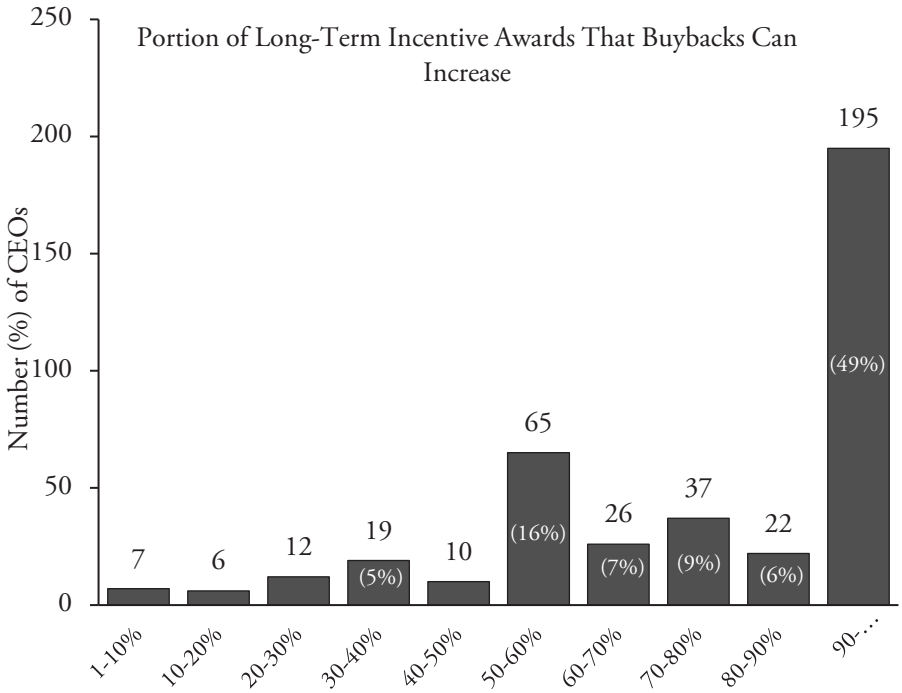
¹⁰⁸ Analyzing how a buyback would help a CEO hit her desired EPS level and thereby increase her long-term performance award is identical to the earlier description of how buybacks help CEOs meet their EPS performance targets and thus boost their annual bonuses.

¹⁰⁹ See Brettell et al., *supra* note 68.

¹¹⁰ *Id.*

¹¹¹ *See id.*

FIGURE IV: DISTRIBUTION OF BUYBACK POTENTIAL TO INCREASE LONG-

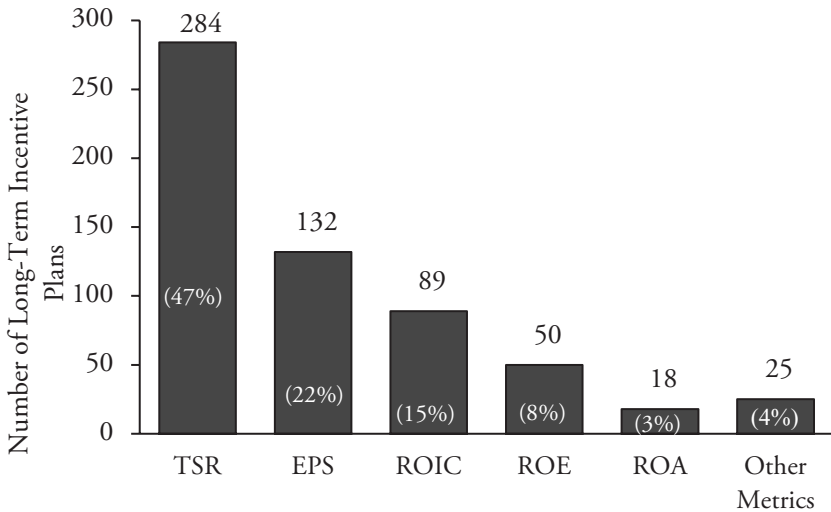


TERM INCENTIVE AWARDS

Source: ISS Incentive Lab.

Sample: Based on 399 CEOs included in the S&P 500 Index. Data as of Q4 2018.

FIGURE V: PERFORMANCE MEASURES IN LONG-TERM INCENTIVE PLANS THAT BUYBACKS IMPROVE



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: LONG-TERM PERFORMANCE DETERMINANTS* THAT BUYBACKS IMPROVE

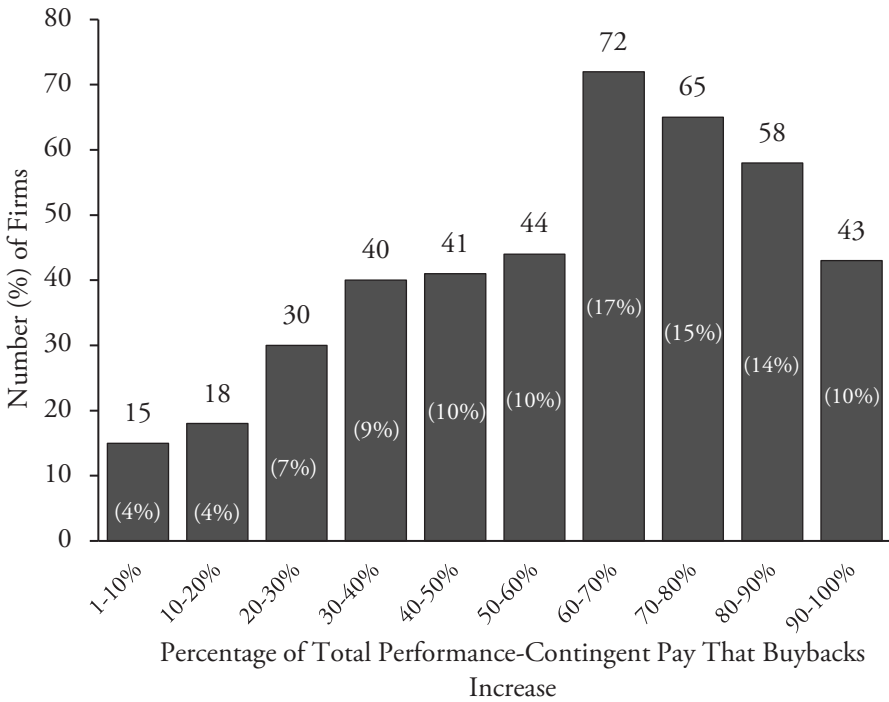
<i>Performance Criterion</i>	<i>Number of Grants</i>	<i>Average Portion of Award That the Criterion Decides</i>	<i>Average \$ Value of Award That the Criterion Decides</i>
TSR	535	64%	3,737,492
ROE	85	58%	3,413,772
EPS	200	45%	2,648,616
ROIC	130	35%	2,060,035
ROA	28	32%	1,883,460

*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.

FIGURE VI: PERCENTAGE OF INCENTIVE COMPENSATION* THAT BUYBACKS INCREASE



* Includes annual bonuses and long-term incentive awards.

Source: ISS Incentive Lab.

Sample: Based on 426 CEOs included in the S&P 500 Index. Data as of Q4 2018.

c. Buybacks' Increase of Total CEO Compensation

In total, and mostly due to their ability to increase long-term incentive awards, stock buybacks give corporate executives an immediate head start in achieving the performance targets that determine most of their incentive compensation. On average, buybacks improve performance criteria that are responsible for 52% of the incentive pay for S&P 500 CEOs (Table III). For the average CEO, this equals to almost one-third of total compensation.¹¹²

The ability of buybacks to improve measures that decide CEO pay varies greatly. While buybacks cannot increase pay for one-third of CEOs, they are able to boost two-thirds of overall performance pay for almost half of CEOs (Figure VI).

¹¹² See *infra* Table III.

An industry analysis reveals that buybacks have the greatest ability to boost CEO pay in large firms and, by sector, in financial and industrial companies.

Notably, the potential of buybacks to increase long-term incentive awards is far greater than their ability to increase annual bonuses. While buybacks help executives meet criteria that decide almost two-thirds of long-term awards, they improve measures that decide, on average, only one-fifth of annual bonuses. Based on the difference in value between short- and long-term awards, buybacks can increase long-term awards valued ten times higher than the amount they can lift annual bonuses.

TABLE III: SUMMARY VALUE OF AWARDS THAT BUYBACKS IMPROVE

	Mean \$ Value (Median)	Mean \$ Value Affected by Buybacks (Median)	Mean Weight Affected by Buybacks (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 S&P 500 CEOs. Data as of Q4 2018.

IV. THE TROUBLE WITH BUYBACKS' IMPACT ON EXECUTIVE COMPENSATION

The potential of stock buybacks to mechanically improve executives' performance measures and thereby increase their compensation motivates executives to conduct buybacks excessively and opportunistically. Moreover, these incentives are camouflaged in firms' public filings. The costs associated with these shortcomings are significant both on a company level and for the economy as a whole.

A. Excessive Buybacks

1. Excessive Buyback Incentives

Having established that stock buybacks can increase executive compensation in the short term, I now explore how this motivates corporate executives to conduct buybacks excessively. Some have argued that we should not be concerned about the incentives that this ability provides corporate executives to undertake stock buybacks.¹¹³ As noted earlier, Jensen's agency cost theory of free cash flows posits that encouraging managers to undertake more buybacks than they would ideally want is desirable.¹¹⁴ If firms do not encourage managers to do so, the argument goes, executives would use the extra cash to reap larger paychecks, consume more perks, and reduce market discipline.

I disagree. First, even if executives have such incentives, their ability to act on them today is far weaker than it was in the 1980s when Jensen's theory was formulated. Today, shareholders are empowered to punish managers who avoid stock buybacks against their will.¹¹⁵ Index fund investors can exercise this power through informal pressure, activist investors are able to launch targeted attacks to fire abusive managers, and institutional investors can launch "Vote No" campaigns against the reelection of uncooperative directors, or cast negative "Say on Pay" votes against compensation plans of executives who abuse companies' excess cash for their own benefit.¹¹⁶

In fact, recent proposals on both sides of the political aisle indicate that corporate executives today are biased in the opposite direction, suggesting that they are being pressed to conduct buybacks even when doing so might compromise their firms' long-term future. Former presidential candidate Hillary Clinton has called

¹¹³ Jensen, *supra* note 25, at 323–24.

¹¹⁴ See discussion in Part II.B.2.

¹¹⁵ See James D. Cox & Randall S. Thomas, *Corporate Darwinism: Disciplining Managers in a World with Weak Shareholder Litigation*, 95 N.C. L. REV. 19, 21 (2016) (noting the variety of strategies that shareholders use to exert influence on managers).

¹¹⁶ See *Passive, but Powerful: How Index Fund Investors Exercise Their Clout*, WHARTON SCH. (Apr. 23, 2015), <https://knowledge.wharton.upenn.edu/article/passive-but-powerful-how-index-funds-exercise-their-clout/> (discussing informal pressure by passive investors); Walter Frick, *The Real Reason CEOs Don't Like Activist Investors*, HARV. BUS. REV. (Mar. 14, 2016), <https://hbr.org/2016/03/the-real-reason-ceos-dont-like-activist-investors> (activist investors often fire CEOs); Del Guercio et al., *Do Boards Pay Attention when Institutional Investor Activists "Just Vote No"?*, 90 J. FIN. ECON. 84, 85 (2008) (campaigns by investors "are effective in spurring boards to act"); GLASS LEWIS, PROXY PAPER GUIDELINES: AN OVERVIEW OF THE GLASS LEWIS APPROACH TO PROXY ADVICE 33 (2019), https://www.glasslewis.com/wp-content/uploads/2018/10/2019_GUIDELINES_UnitedStates.pdf (recommending voting against a Say on Pay proposal in certain circumstances).

for curbs on buybacks because some shareholders, in their pursuit of “quarterly capitalism,” successfully demand that corporate managers use buybacks excessively in order to create a façade of better short-term performance and to support higher stock prices.¹¹⁷ Former President Donald Trump attempted to limit this relentless short-term shareholder pressure by proposing to end the corporate practice of publishing quarterly earnings reports.¹¹⁸

Second, I argue that even if executives today are still able to generate agency costs of free cash flows, current compensation plans motivate them to conduct some stock buybacks even if this would certainly destroy firm value. A buyback is expected to destroy firm value when the forgone return the company would generate absent the repurchase exceeds the return shareholders are expected to generate from other investments on the money distributed via the buyback.¹¹⁹

The incentive to conduct excessive buybacks arises when the buyback increases executive compensation in the short term and this extra compensation is not offset in the long term.¹²⁰ In the short term, an excessive buyback can improve EPS because, while the decline in earnings will ensue only gradually and only in the future, the buyback automatically reduces the company share count and therefore can immediately increase EPS, even if it has a negative effect on the firm’s value. Moreover, the short-term increase in EPS would likely increase the short-term demand for the company stock. This can increase short-term TSR even in the absence of higher corporate revenues or profits. Indeed, previous studies have found that buybacks that aim to meet or exceed analyst expectations improve short-term TSR.¹²¹ In addition, a company’s repurchase of its own stock creates extra demand for the stock and shortage of supply, thereby increasing near-term TSR even further.¹²²

In the long term, however, the undue impact of stock buybacks on the firm’s

¹¹⁷ See Allen, *supra* note 6.

¹¹⁸ See Jeff Cox, *Trump Pushes for an End to Quarterly Earnings Reports as a Way to Help Business Do ‘Even Better,’* CNBC (Aug. 17, 2018, 5:31 PM), <https://www.cnbc.com/2018/08/17/trump-pushes-for-an-end-to-quarterly-earnings-reports.html>.

¹¹⁹ Such returns should be calculated on a risk-adjusted present value basis in order to factor in risk and time. One can imagine that a sole owner in an all-equity firm who expects to hold her full ownership stake indefinitely would have optimal buyback incentives.

¹²⁰ The short-term improvement of performance measures not only applies to annual bonuses but also to long-term incentive awards. Long-term awards are typically predicated on performance measured over a three-year period. For example, a long-term award may be based on the company’s three-year EPS performance. A buyback conducted in the third year would mechanically improve the EPS mark that would determine the long-term performance award.

¹²¹ See, e.g., Paul Hribar et al., *Stock Repurchases as an Earnings Management Device*, 41 J. ACCT. & ECON. 3, 17–23 (2006) (reporting that, although the premium they receive is 60% lower than others, firms that meet or exceed analyst expectations only because of a repurchase still receive a valuation premium).

¹²² *Id.* at 5–6.

performance criteria dissipates, and the true economic impact of the buyback remains. Hence, in the long term, excessive buybacks can be expected to adversely affect EPS and TSR, reflecting the loss in economic value. For example, if the buyback is expected to reduce firm earnings permanently by 1%, the long-term EPS and TSR should decline by 1% as well.

While excessive buybacks reduce long-term performance measures in proportion to the fundamental economic loss they trigger, that might be insufficient to offset the undue boost in executive compensation in the short term. For example, if the buyback stands to increase short-term pay for the executive by 5%, but reduce her long-term pay and firm value only by 2%, the executive's net compensation would increase by 3%. This expected increase in compensation would motivate the executive to conduct the buyback despite its negative effect on the firm's value.

CEO incentives to conduct buybacks that destroy firm value become even more disturbing when we consider three additional factors. First, because CEOs do not stay indefinitely with the firms they run, they might not privately suffer the full adverse long-term impact of excessive buybacks on their pay. Second, firms can, and often do, conduct buybacks on a regular basis.¹²³ This prolongs the short-term boost that buybacks provide to executive pay by keeping EPS higher than earnings and boosting the stock price and TSR into the long term. As noted before, Goldman Sachs confirms that buybacks maintain a significant and consistent gap between EPS and earnings over a long period, and argues that continuing high buyback activity will support a high TSR.¹²⁴ Third, the immediate stock price pop that some excessive buybacks trigger improves the short-term unloading conditions for CEO stock compensation. This, in turn, increases even further the short-term increase in CEO pay that such buybacks create.

Moreover, CEO incentives to conduct excessive buybacks are not tempered when the reduction in share count and in-stock supply that buybacks impose is offset by new stock issuances.¹²⁵ While the amount of new issuances is pretty much fixed, the amount of stock repurchases is significantly flexible. New issuances are

¹²³ See JAY B. SYKES, CONG. RESEARCH SERV., LSB10266, STOCK BUYBACKS: BACKGROUND AND REFORM PROPOSALS 1–2 (2019).

¹²⁴ See Pound, *supra* note 2.

¹²⁵ See Fried & Wang, *supra* note 10, at 219 (reporting that much of the capital distributed by S&P 500 firms to shareholders via repurchases is returned to the firms via equity issuances).

typically predetermined because they are mostly triggered by employee and executive equity plans.¹²⁶ However, buyback executions can, and often do, materially deviate from board-approved buyback plans.¹²⁷ For example, if planned issuances to employees and executives total 50 shares, and the board has approved a plan to buy back 100 shares, the executive will improve her EPS and many other performance measures if she manages to push the firm to repurchase more than half of the approved buyback plan. At the same time, the executive is not likely to have the power to reduce the new issuances.

2. *The Cost of Excessive Buybacks*

a. *Undermining Investment in Productive Capabilities*

When a company spends too much cash on stock buybacks, too few resources are left for investment, research and development, innovation, and employee welfare.¹²⁸ Why invest in the long term when you are overcompensated for boosting your earnings now? That is the perverse incentive that most CEOs currently face.

Continuous underinvestment in long-term projects can lead to individual companies' suicides,¹²⁹ and to the U.S. economy's decline in competitiveness internationally.¹³⁰ Take, for example, the tremendous investment required to develop fifth-generation wireless (5G) technology. While Cisco used its repatriated cash to boost its earnings through a gigantic \$38 billion in stock buybacks in 2018 and 2019,¹³¹

¹²⁶ See Stephen B. McKeon, *Employee Option Exercise and Equity Issuance Motives* (Oct. 2, 2015) (unpublished manuscript at tbl. 5), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1920985 (reporting that between 1985 and 2011 proceeds that firms received from employee-initiated equity issues made up almost 40% of proceeds of all cash-raising equity issuances, including IPOs, SEOs, and private placements). Because IPOs are not relevant for public firms, employee-related equity issuances made up a higher portion of their total issuances. *Id.*

¹²⁷ See Larry Swedroe, *Are Stock Buybacks Bad for Shareholders?*, EVIDENCE-BASED INVESTOR (Dec. 21, 2019), <https://www.evidenceinvestor.com/are-stock-buybacks-bad-for-shareholders/> (reporting that outside the U.S., the average completion rate of announced buybacks is 28% after one year and 40% after two years, while U.S. firms have completion rates of 75% and 85%, respectively).

¹²⁸ See William Lazonick, *Profits Without Prosperity*, HARV. BUS. REV. (Sept. 2014), <https://hbr.org/2014/09/profits-without-prosperity> [hereinafter Lazonick, *Profits Without Prosperity*]; William Lazonick, *The Value-Extracting CEO: How Executive Stock-Based Pay Undermines Investment in Productive Capabilities* 14 (Inst. for New Econ. Thinking, Working Paper No. 54, 2016), https://www.ineteconomics.org/uploads/papers/WP_54-Lazonick-Value-Extracting-CEO-Mod-2017.pdf.

¹²⁹ See Ayres & Olenick, *supra* note 5, at 16–17.

¹³⁰ See Lazonick, *Profits Without Prosperity*, *supra* note 128.

¹³¹ See Trefis Team, *Why Is Cisco's Stock up 75% in the Last 3 Years Despite Weak Revenue Growth?*, FORBES (June 5, 2020, 12:00 PM), <https://www.forbes.com/sites/greatspeculations/2020/06/05/why-is-ciscos-stock-up-75-in-the-last-3-years-despite-weak-revenue-growth/?sh=>

its Chinese competitor Huawei did not repurchase stock at all. Instead, it reinvested its entire profits in the business.¹³² This investment in R&D helped Huawei take the lead over Cisco and other U.S. tech companies in the 5G race.¹³³

Moreover, when executives conduct buybacks excessively, they waste the taxpayer money that finances tax breaks, such as the December 2017 Tax Cuts and Jobs Act. The justification for the \$1.5 trillion tax windfall that the Act provided was that it would stimulate the economy by raising output over the long term and by increasing average household wages.¹³⁴ However, using this tax subsidy to finance excessive buybacks, aimed in part to boost CEO compensation, defeats this purpose.¹³⁵

5d1670315200; see also *Three Things You Should Check Before Buying Cisco Systems, Inc. (NASDAQ:CSCO) for Its Dividend*, SIMPLY WALL ST, (Jan. 17, 2020), <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).

¹³² See Sheelah Kolhatkar, *The Economist Who Put Stock Buybacks in Washington's Crosshairs*, NEW YORKER (June 20, 2019), <https://www.newyorker.com/business/currency/the-economist-who-put-stock-buybacks-in-washingtons-crosshairs> (quoting William Lazonick: "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*, IRISH TIMES (Mar. 30, 2018, 2:15 PM), <https://www.irishtimes.com/business/technology/huawei-spends-record-14bn-on-r-d-1.3445620>.

¹³³ See Brian Fung, *How China's Huawei Took the Lead over U.S. Companies in 5G Technology*, WASH. POST (Apr. 10, 2019 1:01 PM), <https://www.washingtonpost.com/technology/2019/04/10/us-spat-with-huawei-explained/>.

¹³⁴ Specifically, the White House claimed that the Act would raise output by 2% to 4% in the long term and boost average household wages by \$4,000. See *The Tax Cuts and Jobs Act*, WHITE HOUSE (Feb. 2018) https://www.whitehouse.gov/wp-content/uploads/2018/02/WH_CuttingTaxesForAmericanWorkers_Feb2018.pdf.

¹³⁵ See Anne Marie Knott, *Why the Tax Cuts and Jobs Act (TCJA) Led to Buybacks Rather than Investment*, FORBES (Feb. 21, 2019, 4:47 PM), <https://www.forbes.com/sites/annemarielknott/2019/02/21/why-the-tax-cuts-and-jobs-act-tcja-led-to-buybacks-rather-than-investment/#62c870bf37fb> (noting that "the dominant company response to the TCJA was stock buybacks. For the first three quarters of 2018, buybacks were \$583.4 billion (up 52.6% from 2017). In contrast, aggregate capital investment increased 8.8% over 2017, while R&D investment growth at US public companies increased 12.5% over 2017 . . ."). The TCJA had two main provisions affecting corporate taxes that stimulated buybacks. First, the Act lowered corporate taxes from a graduated structure with a maximum rate of 35% to a flat rate of 21%. Second, it encouraged repatriation of estimated \$2.8 trillion in pre-2018 foreign profits by offering them a tax "holiday" at a reduced rate of 15.5% on liquid assets "and 8% percent on other assets." *Id.*; see also Jim Tankersley, *Trump's Tax Cut One Year Later: What Happened?*, N.Y. TIMES (Dec. 27, 2018), <https://www.nytimes.com/2018/12/27/us/politics/trump-tax-cuts-jobs-act.html>.

b. Creating a Market Bubble

Using resources that could finance long-term projects to create hollow demand for a company's stock can inflate the stock price. Goldman Sachs reports that the majority of demand for stock in the U.S. comes from issuers themselves through stock buybacks rather than from demand motivated by improved economic fundamentals.¹³⁶ This distortion is exacerbated by the ability of buybacks to mechanically improve performance measures that stock traders rely on heavily, replacing them with the illusion of continuously improving EPS.¹³⁷

When the artificial demand and faked performance that excessive buybacks create are systemic, they can lead to a stock market bubble and a macroeconomic catastrophe. When buybacks decline, which can happen when the Federal Reserve pushes interest rates back up, the "mother of all credit bubbles" could burst,¹³⁸ possibly leading to another stock market crash and a recession.

Unfortunately, unlike buy-and-hold investors, corporate executives can hedge their personal risk against a future bust in the equity bubble that their excessive buybacks create. Following the same pattern as top executives at Lehman Brothers and Bear Stearns in the years preceding the 2008 financial crisis,¹³⁹ corporate executives can unload their stock and option compensation at the inflated prices that buybacks support. Indeed, SEC Commissioner Rob Jackson has found that executives already capitalize on these favorable price levels to sell their holdings.¹⁴⁰

c. Distorting Capital Structure

When firms repurchase their own stock excessively, they reduce their equity too much, resulting in overly high financial leverage. Because the financing of at least one-third of shares repurchased in buybacks comes from borrowed money,¹⁴¹ buybacks commonly increase financial leverage even further. A company that is overleveraged incurs a greater risk of bankruptcy if its business encounters difficulties. Because CEO incentives to conduct excessive buybacks are marketwide, the

¹³⁶ See Mohamed, *supra* note 13.

¹³⁷ See Lance Roberts, *Aaand It's Gone . . . The Biggest Support For Asset Prices*, SEEKING ALPHA (Apr. 6, 2020, 7:10 AM), <https://seekingalpha.com/article/4336138-aaand-gone-biggest-support-for-asset-prices>.

¹³⁸ Pearlstein, *supra* note 13; see Mohamed, *supra* note 13 (reporting that one in five companies already has debt-service obligations that exceed its cash flow).

¹³⁹ See, e.g., Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. ON REG. 257, 260 (2010).

¹⁴⁰ See Jackson, *supra* note 27.

¹⁴¹ See Pearlstein, *supra* note 13 (noting that corporate debt finances at least one-third of stock buybacks); see also Jesse Colombo, *When the Stock Buybacks Go Bye-Bye*, FORBES (Dec. 31, 2018, 5:18 PM), <https://www.forbes.com/sites/jessecolombo/2018/12/31/when-the-stock-buybacks-go-bye-bye/#4683fc15dedf> ("U.S. corporations have taken advantage of ultra-low bond yields to borrow heavily in the corporate bond market to fund buybacks.").

elevated leverage that these buybacks create increases the likelihood of a macroeconomic bust.

d. Value Diversion

When buybacks are motivated by their ability to increase executive compensation, they transfer value from firms to their executives. For example, suppose an excessive or an opportunistic stock buyback boosts performance measures, which results in a CEO receiving awards worth \$10 million, though absent the repurchase she would have received awards valued at only \$7 million. As a result, she receives \$3 million that otherwise could have been used for investment, as reserves on the balance sheet, or for increasing distributions to shareholders.

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 \$1.90 target EPS required by his annual bonus plan.¹⁴² Because (i) his bonus was \$1.01 million, (ii) the EPS measure decided half of it, and (iii) achieving target EPS awarded him double the bonus he would have received for attaining the threshold EPS level,¹⁴³ the repurchase diverted over \$250,000 from the company to Mr. Tucci.

e. Harming the Ability to Signal Undervaluation

Executive incentives to conduct buybacks even when they may destroy firm value harm the ability of well-intended managers such as Warren Buffett and Charlie Munger to use buybacks to signal undervaluation of their company's stock.¹⁴⁴ Buybacks undermine undervaluation signaling because investors cannot distinguish between buybacks that genuinely signal undervaluation, and therefore benefit long-term investors, from buybacks that are motivated by CEOs who want to enrich themselves—even when that would harm long-term investors.

This investor confusion thus harms market efficiency. When markets confuse buybacks motivated by undervaluation with those done to benefit CEOs, they can wrongfully reward ill-motivated buybacks and punish well-intended repurchases. These mixed signals distort stock pricing and undermine the credibility of equity markets.

f. Disguising Poor Business Performance

The ability of excessive buybacks to confuse investors can also serve to camouflage lack of business success. This concern is heightened by the fact that the biggest

¹⁴² See Brettell et al., *supra* note 68.

¹⁴³ EMC Corp., Proxy Statement (Form DEF 14A) 62 (Mar. 20, 2015), <https://www.sec.gov/Archives/edgar/data/790070/000079007015000072/definitiveproxyforyearende.htm>.

¹⁴⁴ See Rotblut, *supra* note 35.

stock repurchasers in the S&P 500 Index last year underperformed that index considerably.¹⁴⁵ These big repurchasers “include Sears, J.C. Penney, Hewlett-Packard, Macy’s, Xerox and Viacom, for all of which the primary purpose of the buybacks was to prop up the stock price in the face of disappointing operating results.”¹⁴⁶

Take, for example, Applied Materials. Despite its 3.5% decline in earnings last year it managed to eke out 1.9% in EPS growth. It managed to disguise its deteriorating performance, in part, by taking over 10% of its shares off the market via buybacks.¹⁴⁷

B. Opportunistic Buybacks

1. Opportunistic Buyback Incentives

Current compensation arrangements not only provide executives with incentives to conduct excessive buybacks but also motivate them to conduct buybacks opportunistically. Opportunistic buyback incentives are created when executives have enough information to engineer a buyback that would allow them to just meet their performance goals, thereby doubling their incentive award.¹⁴⁸

For example, when the CEO knows that she precisely needs a buyback of 1% of the company stock to just hit her EPS goal, she is opportunistically motivated to undertake the buyback. Indeed, recent academic studies confirm that companies are more likely to repurchase shares and spend more on repurchases when they would just miss their EPS forecast in the absence of the repurchase.¹⁴⁹ Moreover, opportunistic buybacks that aim only to meet EPS expectations tend to immediately boost the stock price, thereby helping executives to meet their TSR goals as well.¹⁵⁰

This incentive stems from the noncontinuous relationship between performance and pay that firms use for their incentive award plans. Because firms commonly use discrete performance levels (minimum, target, and maximum), with each corresponding to a significantly different pay level, buyback incentives depend on

¹⁴⁵ See Michael Wursthorn, *Stock Buybacks Are Booming, but Share Prices Aren't Budging*, WALL STREET J. (July 8, 2018, 9:00 AM), <https://www.wsj.com/articles/stock-buybacks-are-booming-but-share-prices-arent-budging-1531054801>; see also Letter from Robert J. Jackson, Jr., Comm'r, Secs. & Exch. Comm'n, to Sen. Chris Van Hollen 4 (Mar. 6, 2019), <https://www.sec.gov/files/jackson-letter-030619.pdf> (reporting that 90 days after buyback announcements, firms with insider cashouts underperform other firms by more than 8%).

¹⁴⁶ Pearlstein, *supra* note 13.

¹⁴⁷ See Jerry Useem, *The Stock-Buyback Swindle*, ATLANTIC (July 26, 2019, 2:08 PM), <https://www.theatlantic.com/magazine/archive/2019/08/the-stock-buyback-swindle/592774/>.

¹⁴⁸ Cf. COMPENSATION ADVISORY PARTNERS, *supra* note 67, at 9–10.

¹⁴⁹ See Almeida et al., *supra* note 28, at 169; see also Sunyoung Kim & Jeff Ng, *Executive Bonus Contract Characteristics and Share Repurchases*, ACCT. REV., Jan. 2018, at 289, 289–90.

¹⁵⁰ See, e.g., Hribar et al., *supra* note 121, at 24.

how close, absent the buyback, an executive's performance would be to each level.

The ability to conduct opportunistic buybacks is not significantly harmed by the time-weighted method used to calculate EPS and other per share performance criteria. As I explain in Part III, because firms follow the GAAP requirement to use the measurement period's weighted average number of shares, the buyback should be done early enough to effectively impact per share measures. Because firms commonly have enough information to issue EPS forecasts, executives can assess in advance the EPS they would achieve absent the buyback. In turn, they can easily estimate the size of buyback that would assist them to just hit their performance measures.

Because a buyback is likely to create an immediate stock price pop, the incentive to conduct opportunistic buybacks increases when executives have more personal stock to unload in the near term. Indeed, firms announce more buybacks when executives have larger numbers of options outstanding,¹⁵¹ and they spend more on each buyback.¹⁵²

Unfortunately, because massive stock sales by the managers can indicate to the markets that this is a good time to sell,¹⁵³ timing buybacks to improve the unloading opportunities of the managers is likely to send the wrong signal and reduce the stock price. Moreover, a series of empirical studies have shown that when managers reduce their skin in the game by unloading their stock, they become worse stewards for shareholders, both in creating shareholder value and in generating operating income.¹⁵⁴

¹⁵¹ See Alex Edmans et al., *The Long-Term Consequences of Short-Term Incentives* 16 (European Corp. Governance Inst., Finance Working Paper No. 527/2017, 2017), https://ecgi.global/sites/default/files/working_papers/documents/edmans-fang-huang.pdf; see also David Moore, *Strategic Repurchases and Equity Sales: Evidence from Equity Vesting Schedules 18–19* (June 26, 2020) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3014462.

¹⁵² See Kahle, *supra* note 40, at 254, 258.

¹⁵³ Alan Gregory et al., *Does the Stock Market Gender Stereotype Corporate Boards? Evidence from the Market's Reaction to Directors' Trades*, 24 BRITISH J. MGMT. 174, 178 (2013).

¹⁵⁴ See, e.g., Randall Morck et al., *Management Ownership and Market Valuation*, 20 J. FIN. ECON. 293, 293 (1988); Robert Tumarckin, *How Much Do CEO Incentives Matter?* (July 11, 2010) (unpublished manuscript), <http://people.stern.nyu.edu/rtumarcki/research/HMDCIM.pdf> (see Abstract, reporting that “[f]or the mean incentive level, Tobin's q increases by 10.0% compared to that of counterfactual firms that lack CEO incentive compensation”). A similar empirical conclusion has been reported by Bhagat and Tookes with regard to the positive effect that directorial equity holding has over future operating performance. See generally Sanjai Bhagat & Heather Tookes, *Voluntary and Mandatory Skin in the Game: Understanding Outside Directors' Stock Holdings*, 18 EUR. J. FIN. 191 (2012).

2. *The Cost of Opportunistic Buybacks*

Similar to excessive buybacks, opportunistic buybacks undermine long-term investments, divert value from firms to their executives, hamper the ability of well-intended managers to signal undervaluation, and disguise poor business performance.

In addition, opportunistic buyback incentives separate pay from performance. The faked performance that such buybacks create in the immediate term rewards executives for what was supposed to be the “real” performance they were supposed to deliver. Large incentive payments are often justified as necessary to align managerial interests with those of their shareholders and to reduce agency costs.¹⁵⁵ However, when pay based on meeting performance targets is achieved by manipulation, the desirable effects of performance-based compensation are undermined.

My industry analysis confirms that the potential to use buybacks to subvert pay-for-performance arrangements increases with the intensity of incentive pay. Table IV indicates, for example, that CEO pay-for-performance arrangements in the real estate sector are the most intense, but also that these executives enjoy the highest ability to inflate their pay through stock buybacks. Likewise, the intensity of performance-based compensation paid to financial firm leaders is the second highest, and their ability to use buybacks to manipulate the metrics that determine their pay is also second highest.

¹⁵⁵ See Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It’s Not How Much You Pay, but How*, HARV. BUS. REV. (May–June 1990), <https://hbr.org/1990/05/ceo-incentives-its-not-how-much-you-pay-but-how> (emphasizing the importance to shareholders of giving executives large incentive-based pay packages to encourage good performance).

TABLE IV: BUYBACKS' ABILITY TO UNDERMINE PAY FOR PERFORMANCE

<i>Industry</i>	<i>Portion of CEO Pay that Buybacks Can Influence</i>	<i>Performance-Based Pay to Total CEO Pay</i>
Real Estate	46%	72%
Financial	41%	62%
Utilities	39%	57%
Materials	35%	53%
Energy	34%	50%
Technology	31%	63%
Health Care	28%	48%
Industrial	25%	48%
Consumer	20%	57%
Communication	20%	67%

Source: ISS Incentive Lab.

Sample: Based on 500 CEOs of firms included in the S&P 500 Index as of Q4 2018.

C. CEOs' Power to Force Their Buyback Preferences

Executives' incentives to undertake buybacks excessively and opportunistically become significantly more troubling when we consider their power to force their undesirable buyback preferences on the firms they run. CEOs have this power due to the lack of shareholder oversight on stock buybacks, because of their direct discretion over buyback decisions, and by reason of the alignment of interest they have with corporate directors both generally and on this specific issue.

1. Sources of CEOs' Power to Force Their Buyback Preferences

In the U.S. there is no direct shareholder oversight over stock buybacks. Under U.S. corporate law, authorization of buyback programs and the execution of a share repurchase do not require shareholder approval.¹⁵⁶ This leaves the board of directors as the only corporate constituency that could potentially prevent CEOs from forcing their buyback agendas.¹⁵⁷

¹⁵⁶ See Lenore Palladino, *The \$1 Trillion Question: New Approaches to Regulating Stock Buybacks*, 36 YALE J. ON REG. BULL. 89, 96 (2018).

¹⁵⁷ Some commentators doubt shareholders' ability to curb executives' appetite to pursue buybacks excessively and opportunistically. Activist shareholders are commonly blamed for pushing firms to conduct stock buybacks and for threatening CEOs to conduct more buybacks if they want to avoid dismissal. See Edward Luce, *US Share Buybacks Loot the Future*, FIN. TIMES (Apr. 26, 2015), <https://www.ft.com/content/1aac576-e9bb-11e4-a687-00144feab7de>.

Moreover, despite the formal prerogative of corporate boards to authorize stock buyback programs,¹⁵⁸ CEOs have significant power over buyback policies. This is due to the direct power of corporate executives to execute stock buybacks and the alignment of interests between CEOs and corporate directors in regard to stock buybacks.

Unlike dividends, as long as a buyback stays within the limit authorized by the board,¹⁵⁹ CEOs have *carte blanche* to decide its amount and timing.¹⁶⁰ Consequently, board-approved repurchase plans are more symbolic than substantive, and buyback completions are often decoupled from the plans that boards approve.¹⁶¹ Moreover, and consistent with my analysis that buybacks increase executive compensation, the average completion rate of buybacks in the U.S. (defined as the percentage of announced buybacks that are actually completed) is more than double the completion rates outside the U.S.¹⁶²

Furthermore, CEO interest in stock buybacks is aligned with that of corporate directors. They both benefit financially from buybacks that increase short-term EPS and TSR. While such buybacks directly increase executive compensation, the resulting stock price bump also improves the unloading conditions for directors' equity compensation. Because 60% of director compensation is currently delivered in the form of stock, option, and equity awards,¹⁶³ this incentive is significant. Indeed, a recent report indicates that corporate insiders take full advantage of the price pop that buybacks create to cash out their equity awards at an inflated value.¹⁶⁴

The ability of CEOs to influence buyback decisions also comes from their general power and influence over the directors in publicly traded U.S. companies. Previous studies have shown that for a variety of financial, social, and psychological

¹⁵⁸ Jesse M. Fried, *Insider Trading via the Corporation*, 162 U. PENN. L. REV. 801, 813 (2014); Palladino, *supra* note 156, at 96.

¹⁵⁹ Palladino, *supra* note 156, at 96.

¹⁶⁰ *See id.*; William Lazonick, *The Financialization of the U.S. Corporation: What Has Been Lost, and How It Can Be Regained*, 36 SEATTLE U. L. REV. 857, 881 (2013); James D. Westphal & Edward J. Zajac, *Decoupling Policy from Practice: The Case of Stock Repurchase Programs*, 46 ADMIN. SCI. Q. 202, 205 (2001); *see also* Robert C. Pozen, *The Board's Role in Share Repurchases*, BROOKINGS (May 4, 2017), <https://www.brookings.edu/opinions/the-boards-role-in-share-repurchases/> (“[I]n many companies, decisions about the level and timing of share repurchases are left to management. . . . The board must formally approve the amount of the company’s quarterly dividend but not its repurchases.”).

¹⁶¹ Westphal & Zajac, *supra* note 160, at 205.

¹⁶² *See* Swedroe, *supra* note 127 (reporting that outside the U.S., the rate after one year is 28% and after two years is 40%, while for U.S. firms the rates are 75% and 85%, respectively).

¹⁶³ EQUILAR, DIRECTOR PAY TRENDS 15 (Nov. 2018) (on file with author).

¹⁶⁴ *See* Jackson, *supra* note 27.

reasons, directors personally benefit from acting in ways that favor the executives.¹⁶⁵ For example, because CEOs have significant influence over the reelection process of incumbent directors, those who oppose a buyback plan that would benefit the CEO face an increased risk that they might not be reelected.

2. Buyback Activity is Consistent with CEOs' Buyback Preferences

As expected from CEOs' power to force their buyback preferences on the firms they run, I find that buyback activity corresponds to CEOs' buyback incentives. This happens because buybacks are highly correlated with their ability to increase CEO compensation. This correlation is high both over time as well as across firms.

a. High Correlation over Time

I find that the dramatic increase in the ability of buybacks to automatically increase CEO pay is highly correlated with the spike in buyback activity. Over the last 20 years, the ability of buybacks to mechanically lift CEO pay increased sevenfold, and the amount firms have used to buy back stock has soared almost sixfold.¹⁶⁶ Moreover, as illustrated in Figure VII, the year-by-year change in stock buybacks tracks very closely the change in the ability of buybacks to increase CEO pay.¹⁶⁷ Indeed, I find that 81% of the increase in buyback activity over the last two decades fully correlates¹⁶⁸ with the increase in the ability of CEOs to boost their paychecks through stock buybacks.

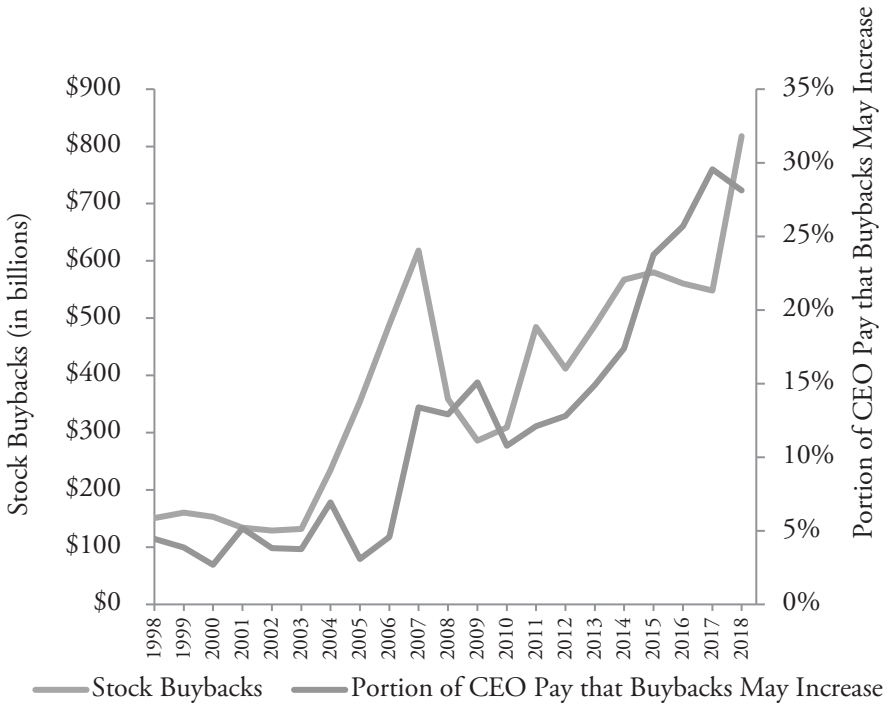
¹⁶⁵ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 23–27 (2004) (describing sources of executives' influence over directors in public companies).

¹⁶⁶ See *infra* Figure VII.

¹⁶⁷ See *infra* Figure VII.

¹⁶⁸ Measured by the Pearson correlation coefficient.

FIGURE VII: STOCK BUYBACKS AND THEIR POTENTIAL TO INCREASE CEO PAY



Source: ISS Incentive Lab, Compustat.

Sample: All firms included in the S&P 500 Index.

The high correlation between buyback activity and CEO pay incentives is especially striking when compared to the low correlations I find between buybacks and each of the widely accepted theories that currently attempt to explain stock buybacks. For example, if firms conducted buybacks to signal that their stock price is undervalued, they would increase buybacks when their stock price is low. However, I find a very low correlation (10%) between buyback activity and bear markets (proxied by the inverse of the S&P 500 Index), suggesting that buybacks do not tend to increase when stock prices are low.¹⁶⁹

Others have theorized that firms repurchase shares because they want to disburse excess cash without having to commit to regular distributions in the future.

¹⁶⁹ A similar argument was made by Professor William Lazonick. See Lazonick, *Profits Without Prosperity*, *supra* note 128 (indicating that over the past two decades major U.S. firms have bought back shares in bull markets and reduced buybacks in bear markets).

However, I find no correlation between buybacks and market uncertainty (measured by the 500 CBOE Volatility Index, known by its ticker symbol VIX).¹⁷⁰ In fact, over the last decade the average VIX has not increased even though buybacks have been booming.¹⁷¹

Changes in the prevalence of employee stock option plans are also not correlated with changes in stock buyback activity. During the past two decades, the number of participants enrolled in these plans has increased only moderately, and the number of such plans has remained steady.¹⁷² By contrast, stock buybacks during that period have soared and have been remarkably volatile.¹⁷³

Finally, if tax considerations explained trends in stock buybacks, a reduction in capital gains tax should have increased stock buybacks. Although the 2017 Tax Cuts and Jobs Act was followed by a spike in stock buybacks, previous changes in tax rules did not seem to be associated with changes in buyback activity. For example, the Taxpayer Relief Act of 1997,¹⁷⁴ which reduced capital gains tax rates, was not followed by an increase in stock buybacks.¹⁷⁵ Moreover, despite the similar reduction in capital gains taxes in both the Economic Growth and Tax Relief Reconciliation Act of 2001¹⁷⁶ and the Jobs and Growth Tax Relief Reconciliation Act of 2003,¹⁷⁷ buybacks did not increase after the former bill passed but soared after enactment of the latter.¹⁷⁸

b. High Cross-Sectional Correlation

I further find that when CEOs have more to gain from stock buybacks, the firms they run repurchase significantly more shares. To test this hypothesis, I ranked all CEOs by the portion of their pay that buybacks could mechanically increase. Compared to the bottom 20% of CEOs, the top 20% use almost three times more of their firms' net income on stock buybacks. The result is not only striking in sheer

¹⁷⁰ The correlation between buybacks and the VIX in the sample is -0.01.

¹⁷¹ Jesse Colombo, *Disaster Is Inevitable when America's Stock Market Bubble Bursts*, FORBES (Sept. 5, 2018, 3:43 PM), <https://www.forbes.com/sites/jessecolombo/2018/09/05/disaster-is-inevitable-when-americas-stock-market-bubble-bursts/>.

¹⁷² See NATIONAL CENTER FOR EMPLOYEE OWNERSHIP, *ESOP By the Numbers* (Sept. 2020), <https://www.nceo.org/articles/employee-ownership-by-the-numbers>; Rebecca Moore, *Number of ESOPs Down, Participants Up*, PLANSPONSOR (Dec. 16, 2015), <https://www.plansponsor.com/number-of-esops-down-number-of-participants-up/>.

¹⁷³ See *supra* Figure VII.

¹⁷⁴ Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

¹⁷⁵ See *supra* Figure VII.

¹⁷⁶ Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 101(c)(3), 115 Stat. 38, 43.

¹⁷⁷ Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301(a), 117 Stat. 752, 758.

¹⁷⁸ See *supra* Figure VII.

volume but is also statistically significant (Mann-Whitney test, $p=0.0275$).

A recent Bloomberg study supports my finding. The study indicates that nearly three-quarters of the CEOs at the top 15 nonfinancial firms that spent the most on buybacks in 2014 were paid based on EPS and TSR, two metrics that get an immediate boost when the company buys back its shares.¹⁷⁹ One of these firms is IBM. The struggling multinational information technology company spent a huge \$13.7 billion on buybacks in 2014.¹⁸⁰ Meanwhile, almost 40% of the \$11.4 million paycheck that IBM CEO Ginni Rometty received in 2014 was based on operating EPS.¹⁸¹

D. Camouflaged Incentives

The incentives that executives have to initiate buybacks are camouflaged. First, public firms do not explicitly disclose the potential of stock buybacks to pump up executive compensation. In fact, not a single firm discloses that buybacks automatically improve many performance criteria that decide executive pay regardless of their impact on firm value.

Second, as discussed earlier, firms rarely disclose if they exclude the mechanical short-term impact of stock repurchases on the performance measures that decide executive pay. This happens in part because current disclosure rules, mandated by Regulation S-K, allow firms to do so.¹⁸² However, firms could disclose information not required by current disclosure rules. Despite the ability of buybacks to increase executive pay, they seem to follow a “lawyerly approach” and reveal no information.

Third, even when diligent and dedicated investors succeed in evaluating the mechanical impact of the buyback on each performance measure separately, they often cannot identify the impact of that performance improvement on executive pay. This occurs because firms often do not disclose the weight of each performance measure in determining specific grants.

¹⁷⁹ See Alex Barinka, *CEOs Dumping Piles of Cash on Shareholders Makes Them Richer*, BLOOMBERG (July 7, 2015), <https://www.bloomberg.com/news/articles/2015-07-07/ceos-get-pay-boost-too-when-they-give-back-cash-to-shareholders>. However, according to a study conducted by Goldman Sachs portfolio strategists David Kostin and Cole Hunter, executives who stand to gain the most from buybacks—those whose compensation depends directly on EPS—did not allocate a greater proportion of total cash spending to buybacks in 2018 than executives whose pay was not linked to EPS. See GOLDMAN SACHS, *supra* note 2, at 4.

¹⁸⁰ Int'l Bus. Machs. Corp., Current Report (Form 8-K) Attachment II, at 11 (Jan. 20, 2015), https://www.sec.gov/Archives/edgar/data/51143/000110465915003332/a15-2313_18k.htm.

¹⁸¹ Barinka, *supra* note 179.

¹⁸² Fried, *supra* note 158, at 815.

Fourth, public investors cannot tell when timing the buyback helps the executive to score a higher incentive award. For example, they do not know if the postponement of the buyback to the end of the year improved EPS significantly enough to allow the executive to achieve a higher performance level.

The camouflage of buybacks' ability to automatically increase executive compensation is troubling. It indicates that firms understand that these incentives are undesirable, because if they were a selling point firms would clearly identify them in their public filings, which in turn would lead to a higher stock price and firm value. Instead, firms hide this information since they are unable to justify the incentives they provide for executives to conduct excessive and opportunistic buybacks.

Regrettably, firms take advantage of this secrecy to engage in lax corporate governance practices. For example, compensation committees abuse secrecy to prevent the full board from discharging its core responsibility to monitor the work of the compensation committee.¹⁸³ In an Investor Responsibility Research Center study, corporate directors revealed that, de facto, their compensation committees project how buyback activity is expected to affect EPS.¹⁸⁴ However, directors report that such discussions take place in the exclusive forum of compensation committees and are not reported to the full board.¹⁸⁵ Indeed, one director who participated in the survey complained anonymously: "I do not see the issues discussed as openly as I might like."¹⁸⁶

In addition to full board members, investors are kept in the dark. By not disclosing these incentives, firms hide from their shareholders the possibility that executives abuse stock buybacks to inflate their own pay. This camouflage prevents shareholders from using their "Say on Pay" votes informatively and effectively and from pressuring firms to modify these incentives. Moreover, secrecy reduces the likelihood of a serious discussion about the desirability of such incentives among

¹⁸³ See DEL. CODE ANN. tit. 8, § 141(a) (2020) (stating that the board of directors has the prerogative to manage the business and affairs of the corporation); see also RICHARD FIELDS, INV'R RESPONSIBILITY RESEARCH CTR. INST. & TAPESTRY NETWORKS, BUYBACKS AND THE BOARD: DIRECTOR PERSPECTIVES ON THE SHARE REPURCHASE REVOLUTION 28 (2016), https://www.tapestrynetworks.com/sites/default/files/publication_pdf/IRRCI%20-%20Buybacks%20and%20the%20Board%20-%20August%202016.pdf ("In some cases, activity in the compensation committee may not be known to the full board.").

¹⁸⁴ See FIELDS, *supra* note 183, at 1–2 (noting that in this study, "Tapestry Networks interviewed 44 directors serving on the boards of 95 publicly traded US companies with an aggregate market capitalization of \$2.7 trillion").

¹⁸⁵ *Id.* at 28 (sharing one director view: "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." Another director said: "It is something that the compensation committee should be aware of and adjust for, but I don't personally know what they've done.").

¹⁸⁶ *Id.*

proxy voting firms and compensation experts.

V. TOWARD BUYBACK-PROTECTED EXECUTIVE PAY

Having established that current pay arrangements provide executives with significant incentives to conduct excessive and opportunistic stock buybacks, and that such incentives are camouflaged in firms' public filings, I turn to the discussion of potential remedies. Despite the significant costs of current buyback incentives, I do not propose banning repurchases or establishing mandatory preconditions for them.¹⁸⁷ I do not support such an approach because buybacks are important in deciding capital allocation and investment policy, and I therefore prefer to allow market forces and business considerations to determine when buybacks are appropriate. Moreover, my proposed remedies currently do not include a change in the allocation of power between managers and shareholders in deciding stock buybacks, which I leave for future research.

Because my objective is to align executive incentives around repurchases with value creation, I propose applying buyback protection to executive compensation arrangements. Borrowing from dividend protection, buyback protection would aim to exclude the mechanical short-term impact on executive compensation triggered by the net change in the number of shares that stock buybacks create. I further argue that the most effective way to make public firms adopt buyback protection is to make that mechanical impact of repurchases on executive pay transparent.

A. Buyback Protection

The concept of excluding the impact of shareholder distributions on executive compensation should be no stranger to corporate America. Firms already apply dividend protection to their compensation arrangements, safeguarding executives from the automatic negative impact that dividends have on their stock options and restricted stock awards.¹⁸⁸ Dividend protection is commonly justified to avoid a chilling effect on executives' incentives to distribute value-increasing dividends.¹⁸⁹ Companies should exclude the mechanical positive impact of stock buybacks on executive compensation with the same rigor and determination that they protect executive compensation from the negative impact of dividends.

While dividend protection aims to eliminate a disincentive for executives to

¹⁸⁷ See, e.g., Schumer & Sanders, *supra* note 8.

¹⁸⁸ See discussion in Part III.A.3.

¹⁸⁹ E.g., Dan Zhang, *CEO Dividend Protection*, 45 J. EMPIRICAL FIN. 194, 194–95 (2018) (arguing that CEO dividend protection can be provided to align managers' incentives with shareholder interests in payout policy).

distribute value-increasing dividends, buyback protection would eliminate their incentives to conduct excessive and opportunistic buybacks.

Shareholders have recently begun to push firms to exclude the impact of stock buybacks on performance measures that determine executive pay. They have submitted proposals to this effect in leading U.S. public firms such as General Electric,¹⁹⁰ Wal-Mart,¹⁹¹ Cisco Systems,¹⁹² American Express,¹⁹³ Boeing,¹⁹⁴ 3M,¹⁹⁵ Illinois Tool Works,¹⁹⁶ and Xerox.¹⁹⁷ As yet shareholders have been largely unsuccessful in convincing firms to adopt their proposals.¹⁹⁸

1. *The Balanced Buyback Protection Rule*

I suggest a novel balanced buyback protection rule (Balanced Buyback Protection Rule) to exclude the impact of the net of: (i) unplanned repurchases; minus (ii) unplanned new issuances, on EPS and other per share performance criteria. Suppose, for example, that a company has periodic earnings of \$100. The company

¹⁹⁰ Gen. Elec. Co., Proxy Statement (Form DEF 14A) 62 (Mar. 12, 2018), <https://www.sec.gov/Archives/edgar/data/40545/000120677418000752/ge3334621-def14a.htm#a62DeductImpactofStockBuybacksfromExecutivePay>.

¹⁹¹ Letter from Kristopher A. Isham, Assoc. Gen. Counsel, Wal-Mart Stores, Inc., to Office of Chief Counsel, Sec. & Exch. Comm'n 2 (Jan. 29, 2016), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/amalgamatedbanks012916-14a8-incoming.pdf>.

¹⁹² Cisco Sys. Inc., Proxy Statement (Form DEF 14A) 68 (Oct. 24, 2018), <https://www.sec.gov/Archives/edgar/data/858877/000119312518306418/d611307ddef14a.htm>.

¹⁹³ Am. Express Co., Proxy Statement (Form DEF 14A) 83 (Mar. 15, 2019), <https://sec.report/Document/0001206774-19-000869/0001206774-19-000869.txt>.

¹⁹⁴ The Boeing Co., Proxy Statement (Form DEF 14A) 77 (Mar. 13, 2009), <https://www.sec.gov/Archives/edgar/data/12927/000119312509053455/ddef14a.htm> (proposing Say on Pay, but not totally omitting buyback effects from compensation).

¹⁹⁵ Cydney 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 in 2016).

¹⁹⁶ *Id.*

¹⁹⁷ 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 Posner, *supra* note 195; *Shareholder Advocacy*, AFL-CIO, <https://aflcio.org/what-unions-do/social-economic-justice/shareholder-advocacy> (last visited Feb. 3, 2021).

¹⁹⁸ See Gen. Elec. Co., Proxy Statement, *supra* note 190, at 62; Cisco Sys. Inc., Proxy Statement, *supra* note 192, at 68; Am. Express Co., Proxy Statement, *supra* note 193, at 84; The Boeing Co., Proxy Statement, *supra* note 194, at 78.

further has 100 shares outstanding in the beginning of the period, does not plan to issue new shares or to conduct buybacks during the period, but nonetheless issues 10 shares and repurchases 20 shares. Applying a Balanced Buyback Protection Rule would exclude the net unplanned reduction of 10 shares, resulting in reduced EPS for executive pay purposes from \$1.11 to \$1.

I argue that new issuances should be deducted from the number of shares repurchased because new issuances increase the number of shares that buybacks reduce. In turn, new issuances mechanically worsen the performance measures that buybacks mechanically improve. Also, I support adjusting those measures only to the unplanned change in the number of shares because the performance measures that boards set should already factor in the repurchases and new issuances that they have planned.

To implement my suggested rule, firms should disclose in advance the assumptions of stock buybacks and new issuances they have made for the purpose of setting their executive pay performance targets. I expect this to impose only a small burden on firms because firms have this information. Such disclosure would ensure a reliable adjustment of executive pay performance measures to the unplanned change in the number of shares.

My suggested Balanced Repurchase Protection Rule is expected to support value creation. It would end executive incentives to conduct excessive and opportunistic buybacks or their parallel incentive to avoid new issuances. Executives would not profit off excessive or opportunistic buybacks because the Balanced Buyback Protection Rule would reverse any unplanned reduction in the number of shares that repurchases trigger, thereby not allowing executives to mechanically improve their EPS or other performance measures for executive compensation purposes. Similarly, executives' motivation to avoid planned issuances would end because the Balanced Buyback Protection Rule would reverse the decrease in the number of shares that doing so triggers.

I argue that my proposed Balanced Repurchase Protection Rule is superior to the two alternatives that shareholders have currently urged on firms with little success.

2. The Budgeting Approach

Shareholder activists have submitted proposals for buyback protection that require firms to consider their planned buybacks when they set their performance goals, and to adjust these measures to account for unplanned repurchases.¹⁹⁹ Let's assume that a company with 110 shares outstanding in the beginning of the period plans to repurchase 10 shares but eventually buys back 20. According to this ap-

¹⁹⁹ See FIELDS, *supra* note 183, at 30.

proach, for calculating performance the company would ignore the unplanned repurchase of the additional 10 shares. Hence, if the periodic earnings were \$100, the EPS for executive pay purposes should be based on a share count of 100 instead of 90, reducing the EPS mark from \$1.11 to \$1.

Policies consistent with the Budgeting Approach have been adopted by IBM, FedEx,²⁰⁰ and Qualcomm.²⁰¹ 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.²⁰²

The Budgeting Approach deviates from my suggested Balanced Buyback Protection Rule by not considering new stock issuances. This is undesirable because adopting the Budgeting Approach can motivate corporate leaders to avoid issuances even when they are value creating. Because the increase in shares that issuances trigger mechanically worsens EPS and other per share measures, executives have an interest in avoiding them. The Budgeting Approach would not alleviate this undesirable incentive because it would not reverse the decrease in the number of shares in response to an unplanned reduction in stock issuances. In contrast, the Balanced Buyback Protection Rule would dodge this undesirable incentive by reversing the decrease in the number of shares that arise from avoiding planned stock issuances.

3. *The Full Exclusion Approach*

Other shareholders have pushed firms to adopt repurchase protection by ignoring the reduction in share count that buybacks—planned and unplanned—automatically trigger (the Full Exclusion Approach).²⁰³ Suppose, for example, that a company has periodic earnings of \$100. The company further has 100 shares outstanding before a buyback and 90 thereafter. Applying the Full Exclusion Approach would exclude the reduction in share count that the buyback imposed, resulting in reduced EPS performance for executive pay purposes from \$1.11 to \$1.

James McRitchie and John Chevedden have recently submitted to IBM a

²⁰⁰ See FedEx Corp., Proxy Statement, *supra* note 69, at 47.

²⁰¹ See Qualcomm Inc., Proxy Statement (Form DEF 14A) 32 (Jan. 24, 2019), <https://www.sec.gov/Archives/edgar/data/804328/000120523319000009/proxy2019.htm>.

²⁰² Int'l Bus. Machs. Corp., Proxy Statement (Form DEF 14A) 24 (Mar. 7, 2016), https://www.sec.gov/Archives/edgar/data/51143/000110465916102981/a16-2282_1def14a.htm.

²⁰³ See Letter from Matt S. McNair, Senior Special Counsel, Sec. & Exch. Comm'n, to Stephen L. Burns, Cravath, Swaine & Moore LLP (Jan. 17, 2018), <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2018/mcritchichevedden011718-14a8.pdf> (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”).

shareholder proposal requesting adoption of the Full Exclusion Approach.²⁰⁴ They specifically urged the IBM board of directors to:

[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.²⁰⁵

By ignoring planned buybacks, the Full Exclusion Approach is not expected to harm executive incentives more than those imposed by the Budgeting Approach, but is likely to create superfluous administrative costs. The incentives are expected to be identical because firms that adopt a Full Exclusion Approach are expected to lower *ex ante* their per share performance criteria to reflect the anticipated extra upward adjustment that this approach would implicate *ex post*. However, the costs associated with such unnecessary *ex ante* adjustment can be costly and burdensome. Therefore, similar to the Budgeting Approach, the Full Exclusion Approach is less effective than the Balanced Buyback Protection Rule.

4. Excluding Impact on TSR

While all forms of repurchase protection aim to exclude the mechanical impact of a change in the number of shares on the per share criteria that determine executive compensation, they do not account for the potential impact of stock buybacks on the stock price and TSR. Unfortunately, the conditions for applying the "safe harbor" protection provided by SEC Rule 10b-18 allow firms to manipulate the stock price and TSR.²⁰⁶ Currently, the rule permits firms to repurchase stock daily up to 25% of the previous four weeks' average daily trading volume.²⁰⁷ Moreover, whereas insiders are required to report their stock transactions within two business days, firms are not required to report stock buyback executions until the next quarterly filing, and even then they are only required to report monthly aggregated amounts.²⁰⁸ This lapse in disclosure is uncommon in other developed markets.²⁰⁹

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ 17 C.F.R. § 240.10b-18 (2020) (preliminary notes).

²⁰⁷ See 17 C.F.R. § 240.10b-18(b)(4).

²⁰⁸ Palladino, *supra* note 156, at 96.

²⁰⁹ In particular, the United Kingdom, Japan, and Hong Kong require companies to disclose stock buybacks within one day. 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> (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

Tightening the safe harbor's daily unloading cap and shortening the gap between buybacks and firms' disclosure of such trades²¹⁰ would weaken the ability of firms to use buybacks to lift their stock price and TSR opportunistically, and would therefore further assist in making executive pay buyback protected.

Importantly, buyback protection does not prevent firms from providing their executives with incentives to conduct stock buybacks.²¹¹ For example, firms that apply buyback protection can still add repurchase amounts as a transparent and explicit performance target, for which executives would be rewarded. Hence, buyback protection does not prevent firms that are concerned about agency costs of free cash flows from providing buyback incentives. Such incentives would avoid the excessive and opportunistic buybacks that firms currently encourage.

B. Improving Transparency

Having shown that executive pay should be protected from the mechanical impact of stock repurchases, I now turn to describing my detailed proposal to make buyback protection transparent. But before discussing the content of my proposal I explain why improving transparency is important as a first step in making firms adopt buyback protection.

1. Transparency Would Push Firms to Adopt Buyback Protection

Requiring firms to apply buyback protection to their executive pay arrangements, for example, by limiting the application of SEC Rule 10b-18 to firms that adopt it, is not expected to be effective. Firms wishing to get around such a rule can argue that they have adopted the Budgeting Approach even when they do not adjust performance measures to reflect their expected buyback activity. Alternatively, they can adopt the Full Exclusion Approach and change the performance measures *ex ante* to undo the expected adjustment that the buyback protection would impose on them *ex post*.

Making the impact of repurchases on executive pay transparent is likely to be more effective. It is expected to provide important information to corporate directors and mobilize them to action. Nearly three-quarters of them already believe that

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."); see also Corzo, *supra* note 5; Palladino, *supra* note 156, at 103.

²¹⁰ For a detailed proposal requiring public firms to disclose trades in firm stock within two business days, see Fried, *supra* note 90, at 9–11.

²¹¹ This ability can be useful for firms that are concerned about their executives' incentives to generate agency costs of free cash flows.

the impact of share buybacks on financial performance assessment should be excluded to some extent.²¹² Moreover, transparency would push firms to adopt buyback protection even if directors do not support it. This is likely to happen because disclosure by firms admitting their lack of buyback protection would raise outrage costs²¹³ that their managers would have to incur. This, in turn, would push managers to adopt buyback protection in order to avoid embarrassment and harm to their social reputation.

In addition, transparency is expected to encourage shareholder action. Because investors currently have to make multiple calculations and assumptions and often end up with ambiguous estimates of the impact of a buyback on executive pay, they might choose to save these costs and avoid engaging in this process. Shareholder action is currently even more unlikely because of their collective action problem. Investors are typically dispersed, and each of them will have to incur the full costs of evaluating the impact of a buyback on executive pay but will benefit from only a fraction of the potential improvement caused by buyback protection.

In contrast, providing shareholders with the processed information they need to successfully evaluate the impact of buybacks on executive pay would greatly alleviate their collective action problem and would clarify the need for shareholder action. Investors who recognize the need for buyback protection can exert effective pressure on firms who refuse to adopt it by threatening to cast a negative “Say on Pay” vote,²¹⁴ by negotiating with firms privately,²¹⁵ by submitting shareholder proposals, and by launching “Vote No” campaigns that target compensation committee chairs who refuse to adopt buyback protection.²¹⁶

Importantly, transparency would assist proxy voting firms such as ISS and Glass Lewis in rewarding firms for having robust buyback protection and in pun-

²¹² See Melissa Burek et al., *Paying for “The Right” Performance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 16, 2019), <https://corpgov.law.harvard.edu/2019/05/16/paying-for-the-right-performance>.

²¹³ 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 165, at 65.

²¹⁴ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 847–48 (1992).

²¹⁵ See James E. Heard, *Executive Compensation: Perspective of the Institutional Investor*, 63 U. CIN. L. REV. 749, 761–62 (1995).

²¹⁶ See Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. CIN. L. REV. 1021, 1021 (1999) (noting that since the stratospheric increases in CEO pay of the 1990s, “[o]utraged 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”).

ishing them for the lack of it. Because these firms' guidelines are followed by institutional investors and firms alike,²¹⁷ incorporating buyback protection in their voting recommendations is critical.

At a minimum, disclosure is expected to push Glass Lewis to account for the impact of repurchases on executive pay in its voting guidelines. Currently, Glass Lewis requires robust discussion of why such a decision was necessary when a company lowers performance goals that determine its executives pay mid-year.²¹⁸ Because having no buyback protection effectively operates to lower performance goals when firms undertake a buyback, Glass Lewis is expected to address the issue of buyback protection once it becomes transparent.

2. Proposal to Make Buybacks' Impact on Executive Pay Transparent

I now turn to discuss my proposal to make the impact of stock buybacks on executive pay transparent. I discuss the content of the proposed disclosures and I explain how they should be integrated into the current framework of disclosure obligations.

I suggest revising Regulation S-K, Item 402, to require firms to provide clear, concise, and understandable disclosure of: (i) the stock buybacks and new issuances that they assumed for setting their executive pay performance targets; (ii) all incentive pay performance measures that buybacks can mechanically improve; (iii) when such performance goals are disclosed, firms shall reveal by how much this increased executive pay for each of the last three years; and (iv) whether they apply buyback protection, defined as a policy that aims to offset, exclude, or reduce the mechanical impact of stock buybacks on performance measures. Firms that apply buyback protection should provide information about the adjustment technique and the rationale behind it. Moreover, if firms do not apply buyback protection, they should state that clearly and explain the reasons for their decision not to do so.

Because these disclosures pertain to executive compensation arrangements, they should be reported in the "Compensation Discussion and Analysis" chapter of the firm's annual proxy statements.²¹⁹ Moreover, because they constitute an integral

²¹⁷ For example, in 2012 firms fortunate enough to receive an ISS "for" recommendation on Say-on-Pay received 95% shareholder support, whereas firms that received an "against" recommendation received only 65% support. See John D. England, *Say on Pay Soul-Searching Required at Proxy Advisory Firms*, in EXECUTIVE PAY AT A TURNING POINT: DEMONSTRATING PAY FOR PERFORMANCE & OTHER BEST PRACTICES IN CORPORATE GOVERNANCE 65, 65–66 (Ira T. Kay ed., 2d ed. 2012). Companies often tailor their policies to meet ISS guidelines, and firms lobby for ISS support to fend off shareholder proposals.

²¹⁸ See GLASS LEWIS, PROXY PAPER GUIDELINES: AN OVERVIEW OF THE GLASS LEWIS APPROACH TO PROXY ADVICE 33–34 (2020), https://www.glasslewis.com/wp-content/uploads/2016/11/Guidelines_US.pdf.

²¹⁹ See Compensation Discussion and Analysis, 17 C.F.R § 229.402(b) (2020).

part of the compensation arrangements of the most highly compensated executives, these disclosures should be subject to an advisory shareholder vote on executive compensation—better known as “Say on Pay.”

VI. CONCLUSION

This Article has exposed an overlooked perspective of stock buybacks—that they can not only increase annual bonuses but can also significantly inflate long-term incentive awards. The Article has also reported that the ability of buybacks to increase long-term incentive awards is 10 times more significant than their ability to inflate annual bonuses, resulting in an overall all-time high ability of buybacks to inflate CEO pay. I have shown that this ability provides corporate executives with incentives to conduct buybacks excessively and opportunistically. I have shown that these incentives arise from the functioning of stock buybacks to improve the performance measures that determine both annual bonuses and long-term incentive awards. My empirical analysis of executive compensation arrangements of CEOs included in the S&P 500 Index has revealed that distorted buyback incentives are significant because the buyback improvement of performance measures such as EPS and TSR is likely to impact most executive incentive awards.

I have explained that my findings are troubling. I have shown that this ability provides executives with incentives to make the firms they run repurchase shares even when they know that the buyback is excessive or opportunistic and that this can cause disastrous results to firms and to the economy overall. I have explained that excessive and opportunistic buybacks undermine firms’ attempts to avoid rewards for business failures, stifle investment in research and development, and create a market bubble that might burst when the overall economy can no longer support the artificial excess demand for equities that these buybacks create.

To remedy these flaws, I have proposed that firms protect the performance measures that determine executive pay from the mechanical boost to common performance criteria that buybacks trigger. I have suggested a novel buyback protection rule that would exclude the impact of net unplanned repurchases on such performance criteria. I have further suggested certain disclosure improvements and tightening of SEC Rule 10b-18 in order to prevent firms from using buybacks to manipulate their stock price and to improve their TSR. I have explained that while a mandatory rule that would require firms to adopt buyback protection is expected to be ineffective, transparency should work better. Transparency is expected to trigger a corporate governance dialogue among firms, boards, investors, and proxy advisors on the need to adopt buyback protection. Making executive compensation buyback-protected deserves the support of all those interested in improving executive compensation plans and in fixing stock buybacks.

More work remains to be done in order to ensure that executive compensation

arrangements do not provide managers with incentives to undertake excessive and opportunistic buybacks. In particular, future research should identify the corporate governance failure that created the flawed incentives I have uncovered and recommend appropriate reforms in the allocation of power to decide on buybacks.