Pay Governance® Advisory Services to Compensation Committees

ALERT

Viewpoint on Executive Compensation

Pay Governance's SEC Comment Letter on Share Repurchase Disclosure Modernization

MIKE KESNER AND IRA T. KAY

Introduction and Background

Pay Governance recently submitted a comment letter to the U.S. Securities and Exchange Commission (SEC) on its proposed rules to modernize the disclosure of share repurchases.[1] As background, the SEC is proposing companies furnish a new form (Form SR) containing detailed information on daily share repurchases no later than one business day after the execution of a repurchase. Though the proposed rules require Form SR to be furnished for each day of a share repurchase process, the SEC is asking the public for opinions regarding level of detail, frequency, and potential exemptions/exceptions. In our comment letter we acknowledge not being experts on share repurchase disclosure, but we wanted to address aspects of the SEC's business case for the proposed changes. Namely, we were concerned with the SEC's reference to claims of certain commentators that share repurchases were being used by executives to unjustly enrich themselves at the expense of shareholders, employees, and long-term investment in the company.

Below are a few of the comments included in the SEC proposal:

- "Share price- or EPS-tied compensation arrangements could incentivize executives to undertake repurchases in an attempt to maximize their compensation."
- "Share repurchases [are used] as a tool to raise the price of an issuer's stock in a way that allows insiders and senior executives to extract value from the issuer instead of using the funds to invest in the issuer and its employees."
- "[There] is the potential for share repurchases to be used by issuers as a mechanism to inflate the compensation of their executives in a manner that is not transparent to investors or the market."[2] In addition to the above, the SEC also indicated the new disclosure requirements "may improve the ability of investors to identify issuer repurchases potentially driven by managerial self-interest, such as seeking to increase the share price prior to an insider sale or to change the value of an option or other form of executive compensation,"[2] further reinforcing the notion that share repurchases are used to benefit executives at the cost of other stakeholders.

Pay Governance's Prior Research on the Effects of Share Repurchases

Pay Governance has previously conducted extensive research among S&P 500 companies and prepared a Viewpoint entitled "Are Share Buybacks a Symptom of Managerial Short-Termism?" in which we concluded:

- Share buybacks did not damage long-term performance or capital investment;
- Shareholder returns were higher for companies that utilize buybacks as part of their capital allocation strategy;
- The use of stock options and earnings per share (EPS)-based incentive plans, rather than encouraging short-term gains at the expense of long-term performance, are correlated with higher long-term TSR; and
- Shareholders do not appear to consider buyback programs to be problematic or create stock price or EPS "myopia" among management teams.[3]

We believe it was important to share these findings with the SEC, helping to "balance" the public record of the rule-making process by providing contrary, fact-based evidence that share repurchases did not come at the expense of shareholder returns and capital investment.

Combatting The Perception That Repurchases Are Used to Unjustly Enrich Management

The comments included in the SEC's proposal suggest boards of directors are either complicit in allowing share repurchases to inflate executive incentive payouts or were somehow being duped by executives. In our comment letter, we noted that boards of directors use several approaches to eliminate or mitigate potential windfalls from share repurchases, including:

- Forecasting the buyback's positive impact on EPS when setting goals at the beginning of the year;
- Adjusting the denominator of a non-GAAP EPS metric in incentive plans at the end of the period by adding back the number of shares bought; or
- Not making any adjustments for the effect of buybacks in the performance goals as well as viewing buybacks as part of the company's overall capital allocation strategy that is evaluated based on the strategic implications/success of the strategy and resulting stock price performance.[1]

We believe it may be appropriate for companies engaged in share repurchases to disclose in the Compensation Discussion and Analysis how such repurchases were factored into incentive plan targets and/or payouts when performance metrics such as EPS, Return on Invested Capital, or other share/capital-sensitive measures are a prominent part of incentive plans. We also recommend that insider trading policies be reviewed to ensure that share repurchases, and insider trading activity, avoid any appearance of executive stock transactions or share repurchase announcements being timed to allow executives to take advantage of share repurchase announcements.

Conclusion

The debate over share repurchases and their effect on stakeholders is far from over and companies need to be proactive in explaining the rationale for, and promoting the benefits of, such repurchases. This will become even more important if the proposed SEC rules are finalized, as company stock repurchases and executive stock transactions will be subject to rigorous and far more frequent disclosure requirements.

General questions about this Viewpoint can be directed to Mike Kesner at mike.kesner@paygovernance.com or Ira Kay at ira.kay@paygovernance.com.

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1 Ira T. Kay and Mike Kesner. "Share Repurchase Disclosure Modernization: Comments from Pay Governance." January 24, 2022. https://www.sec.gov/comments/s7-21-21/s72121-20112752-265473.pdf.

2 U.S. Securities and Exchange Commission. December 15, 2021. https://www.sec.gov/rules/proposed/2021/34-93783.pdf.

3 Ira T. Kay and Blaine Martin. "Are Share Buybacks a Symptom of Managerial Short-Termism?" Pay Governance. May 14, 2019. https://www.paygovernance.com/viewpoints/are-share-buybacks-a-symptom-of-managerial-short-termism.