



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

September 12, 2018

The Honorable Tammy Baldwin  
United States Senate  
709 Hart Senate Office Building  
Washington, DC 20510

Dear Senator Baldwin:

Thank you for your June 28, 2018 letter regarding stock buybacks by public companies. In your letter, you express concern about the magnitude of stock buybacks and their consequences. You specifically note that the funds used for stock buybacks could instead be directed to employees and investments. You also express concern regarding significant sales of stock by corporate insiders following the announcement that their company intends to purchase stock.

We are aware of various important, and in some cases interrelated, policy issues that have arisen in the context of stock buybacks, including, but not limited to:

1. In the area of corporate planning, execution and performance, (a) strategic and management issues involving capital structure and liquidity (e.g., the optimal debt to equity ratio in the near term and over time), (b) capital allocation issues, including investments in employees, equipment and research (e.g., whether to build and staff a new facility) and (c) issues associated with structuring and setting executive compensation (e.g., selecting the amount and mix of current and deferred compensation as well as whether it should be paid in cash, stock or other instruments and whether it should be subject to vesting or other restrictions);
2. In the area of market integrity and trading regulation, whether the buyback activity is inappropriately affecting the stock price and whether company personnel or other market participants are taking unfair advantage of the buyback activity; and
3. In the area of investor protection and disclosure regulation, whether the company has appropriately disclosed its buyback activity and whether company insiders have appropriately disclosed any sales of company stock.

These issues, particularly those in the first category, are themselves affected by a wide array of factors. The factors can be complex, as well as company and industry specific, and to name a few, include conditions in the capital markets (debt and equity), past and expected future

company performance and the related impacts on company value and shareholder returns,<sup>1</sup> the performance of suppliers and customers, actual and potential shareholder initiatives, the actions of competitors, restrictive covenants in lending documents and other contractual obligations,<sup>2</sup> our federal securities laws and Commission rules, state corporate law, federal and state tax law,<sup>3</sup> industry regulations and policy as well as the laws and regulations of other countries.

In general, the Commission is not authorized to prescribe corporate actions in the area of corporate planning, execution and performance. In other words, the Commission is not authorized to direct the strategic decisions that public companies make in operating and financing their businesses. In this regard, how a public company structures its financial affairs, including its allocation of capital, generally is a strategic decision for its management and board of directors. More specifically, if a company has excess capital beyond its projected operational needs, excess capital generally can be invested in employees, equipment or research, returned to shareholders in the form of dividends, used to conduct stock repurchases from shareholders who are willing to sell at the offered price, and/or allocated in some other manner that the board of directors believes appropriate.

These capital allocation decisions are not free from regulation. They generally are subject to state corporate law fiduciary duties based on the specific facts and circumstances applicable to the company, including factors of the type discussed above. In addition to fiduciary obligations, dividend and share repurchase decisions generally are subject to specific limits imposed by state corporate law (e.g., laws requiring sufficient capital surplus for dividends and share repurchases)<sup>4</sup> and, in certain industries such as banking, insurance and utilities, regulatory restrictions and/or approval requirements on dividends and share repurchases.<sup>5</sup>

The Commission does not regulate capital allocation decisions in the way that banking and utility regulators do and does not have the power to do so. However, when a public company does conduct a stock buyback, the Commission focus is on two key regulatory areas described above: (1) market integrity and trading regulation; and (2) investor protection and disclosure regulation.

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<sup>1</sup> See, for example, the discussion of capital structure, including the issue of companies increasing their debt-to-equity ratio by borrowing money and/or repurchasing stock, in the following articles: Harry DeAngelo et al., *Capital Structure Dynamics and Transitory Debt*, 99 J. FIN. ECON. 235 (2011); Anat R. Admati et al., *The Leverage Ratchet Effect*, 73 J. FIN. 145 (2018).

<sup>2</sup> For example, covenants in “high yield” bonds often include limitations on dividends and other “restricted payments” such as share repurchases. See William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process*, 7 Eur. Bus. Org. L. Rev. 39-87 (2006), available at <https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1575&context=facpub>.

<sup>3</sup> For example, for significant classes of U.S. investors, stock repurchases are generally viewed as a more tax efficient method for distributing capital to shareholders than dividends.

<sup>4</sup> In general, under state corporate law, directors can face individual liability if the payment of a dividend or a share repurchase is not in compliance with these specified capital requirements. See *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 982 (Del. Ch. 2010).

<sup>5</sup> See, for example, Bloomberg, *What to Watch When the Fed Releases Bank Stress Tests Today*, June 21, 2018, available at <https://www.bloomberg.com/news/articles/2018-06-21/what-to-watch-when-the-fed-releases-bank-stress-tests-today>.

If a registrant determines to conduct buybacks in the open market, the buybacks must not violate the anti-manipulation provisions of the federal securities laws, specifically Sections 10(b) and 9(a)(2) of the Securities Exchange Act of 1934 (Exchange Act), and Rule 10b-5 and Regulation M. This means that registrants may not engage in stock buybacks for the purpose of manipulating or otherwise artificially increasing the price of their securities. Rule 10b-18 is a Commission rule that provides a conditional, voluntary safe harbor for registrants that are repurchasing their stock without a manipulative purpose but are concerned that their stock buyback activity could have an inadvertent effect on the market. The Rule's conditions on the price, timing, volume, and manner of the buybacks are intended to minimize their market impact.

In addition, our laws and regulations prohibiting insider trading, including Rule 10b-5, apply to buybacks as well as sales of stock by company insiders. In short, a company cannot repurchase shares in the open market if it has material, non-public information and an executive cannot sell stock in the open market if she is in possession of material, non-public information. Please note that this prohibition, and its enforcement by the Commission and other authorities, can have the effect of concentrating company buybacks and insider open market sales in the relatively short periods following earnings releases.<sup>6</sup>

In enforcing the anti-manipulation and insider trading provisions of the federal securities laws, the Commission's staff investigates potential attempts by market participants and registrants to engage in insider trading or artificially affect a security's market price—whether in pump-and-dump schemes or when a registrant is involved in trading to create a false or deceptive picture of the demand for its securities. Specifically, the Commission investigates and has brought enforcement actions connected to stock buybacks, including for insider trading.<sup>7</sup>

With regard to investor protection and disclosure regulation, the Commission has adopted rules that specifically require registrants to disclose information about repurchases of registered equity securities. The disclosure requirements are intended to promote transparency about repurchases and the extent to which registrants follow through with publicly announced repurchase plans. The disclosure rules also enable investors to evaluate the use of buybacks on a company-by-company basis, allowing for more informed investor decisions. Commission rules require registrants to disclose all purchases regardless of whether or not such purchases were made under the Rule 10b-18 safe harbor. In addition, when senior executives sell stock in the

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<sup>6</sup> For example, model trading policies for companies restrict trading to “window periods” that commence shortly after the quarterly earnings release and terminate prior to the quarter end. *See Our Model Insider Trading Program*, THE CORPORATE COUNSEL, Vol. XXXVI, No. 1 (Jan. – Feb. 2011).

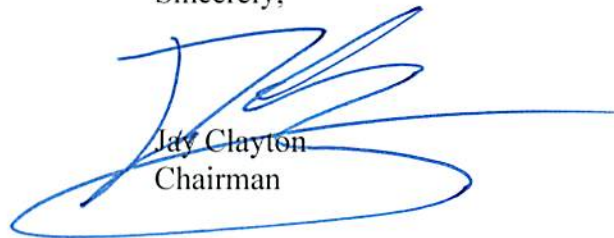
<sup>7</sup> *See, e.g., In re Mizuho Securities USA LLC*, Release No. 34-83685, 2018 WL 3528370 (July 23, 2018) (broker-dealer failed to safeguard inside information pertaining to its issuer customers' stock repurchase programs); *SEC v. Wang*, No. 13-cv-2270 (S.D. Cal.) (insider used secret offshore account to make unlawful trades based on confidential information about stock repurchase program); *SEC v. Stiefel Laboratories Inc.*, No. 11-cv-24438 (S.D. Fla.) (CEO allegedly defrauded shareholders by using stock repurchase program to buy back stock at severely undervalued prices and then selling the stock to the company at a substantial premium); *SEC v. Devlin*, 08-cv-11001 (S.D.N.Y.) (registered representative tipped inside information about stock repurchase program).

open market, pursuant to Section 16 of the Exchange Act, they are required to publicly disclose the transactions within two business days.

To summarize the above discussion, the Commission does not have the authority to prescribe capital allocation decisions, including buybacks, and buybacks are not, nor have they ever been restricted by the Commission. That said, if a company determines a buyback is appropriate, we are keenly focused on (1) market integrity and trading and (2) investor protection and disclosure regulation, and stand ready to enforce our anti-manipulation, insider trading and disclosure laws and regulations. To that end, while I currently do not have a plan to open a comment file relating to Rule 10b-18, I am glad to meet with interested parties, including investor groups, to discuss these issues and possible amendments to the Commission's anti-manipulation and disclosure-based rules.

Thank you again for your letter and please do not hesitate to contact me at (202) 551-2100, or have your staff contact Bryan Wood, Director of the Office of Legislative and Intergovernmental Affairs, at (202) 551-2010, if we can be of further assistance.

Sincerely,



Jay Clayton  
Chairman