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A Critical Approach to the Regulation of a Public Corporation's Purchase of Its Own Shares on the Open Market: Lessons from The Transatlantic Comparison

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A CRITICAL APPROACH TO THE REGULATION OF A PUBLIC CORPORATION'S PURCHASE OF ITS OWN SHARES ON THE OPEN MARKET: LESSONS FROM THE TRANSATLANTIC COMPARISON

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ABSTRACT

Open market repurchases (OMRs)—by far the most common form of share repurchases—have reached record levels following the dramatic increase in number since the adoption of the safe harbor rule in the US. This dramatic increase has been largely attributed to purported benefits of OMRs that matter especially within the Anglo-American economic and corporate model. However, these benefits fail to fully explain such increase. This failure suggests that illegitimate purposes, which could easily be concealed beneath purported benefits, might have also contributed to the increase in the number of OMRs and resulted in their excessive use. This suggestion is supported by the ineffectiveness of the safe harbor rule applicable to OMRs in the US that paves the way for the exploitation of OMRs by corporate actors having inside or superior information. On the other hand, any and all share repurchases used to be strictly regulated in the EU. However, some EU Member States and later the EU itself relaxed legal capital rules including the rule on share repurchases and adopted a safe harbor rule on OMRs that is essentially similar to that in the US. This substantial legal convergence has also been followed by an increase in the number of OMRs in the EU. Notwithstanding that the increase in the EU has been more rapid than that in the US, the number of OMRs in the EU has been much lower than in the US. The less frequent use of OMRs supports the claim that corporations substantially persist in the Continental European model. In this model, the purported benefits of OMRs have been less significant and the potential of abuse of OMRs have been less probable than in the US. Such persistence has also been partly reflected on the OMR regulation in the EU that prescribes a less ineffective framework than that in the US through a few but crucial regulatory technical differences. Hence, this dissertation compares and contrasts rules and practices relating to OMRs on both sides of the Atlantic and

comes up with a series of regulatory proposals to maintain the purported benefits while curbing the number and eliminating the potential drawbacks arising from the abuse of OMRs, particularly in the US but also in the EU and elsewhere. These proposals include two main easy-to-implement regulatory policy proposals, namely the enhancement of current disclosure requirements and the increase of oversight mechanism on OMRs, and a number of complementary proposals that include recommendations for various market actors to reduce the excessive use of OMRs.

In Loving Memory of

Meysam Saidi

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LIST OF ABBREVIATIONS

CDR	Commission Delegated Regulation (EU) 2016/1052
C.F.R.	Code of Federal Regulations
DRIP(s)	Dividend Reinvestment Plan(s)
EC	European Commission
EC Regulation	European Commission Regulation (EC) No 2273/2003
EEC	European Economic Community
EPS	Earnings Per Share
ESMA	European Securities and Markets Authority
ESOP(s)	Employee Share Ownership Plan(s)
EU	European Union
MAD	Market Abuse Directive 2003/6/EC
MAR	Market Abuse Regulation (EU) No 596/2014
NPV	Net Present Value
OMR(s)	Open Market Repurchase(s)
SCD	Second Council Directive 77/91/EEC
SEC	Securities and Exchange Commission
UK	United Kingdom
US	United States
U.S.C.	United States Code

A CRITICAL APPROACH TO THE REGULATION OF A PUBLIC CORPORATION'S PURCHASE OF ITS OWN SHARES ON THE OPEN MARKET: LESSONS FROM THE TRANSATLANTIC COMPARISON

CHAPTER I. INTRODUCTION

A. Research Question

Open market repurchases (OMRs)[1]—transactions which enable public corporations[2] to repurchase their own shares on the open market at the market price—are significant but complex tools at the intersection of corporate finance and corporate governance. The significance of OMRs stems from their prevalence in the United States (US) over the past four decades (see Appendix 1),[3] and to a lesser extent in the European Union (EU) in the last three decades (see Appendix 2).[4] The complexity of OMRs dates back to the nineteenth century when American and British courts

[1] This particular corporate transaction is known by a number of terms including (normal course) issuer repurchases/bids and open market share/stock buybacks/repurchases. This dissertation mainly uses the term open market repurchases and OMRs as the abbreviated form.

[2] While this dissertation mainly uses the term corporation in describing the particular legal entity with a view to providing terminological consistency, the term is substituted by a number of terms including company, firm, and issuer depending on the context.

[3] For the increase in the number of share repurchases in the US, see also Gustavo Grullon & Roni Michaely, *Dividends, Share Repurchases and the Substitution Hypothesis*, 57 J. FIN. 1649, 1655 tbl.1 (2002) (showing the increase in the number of share repurchases over the period 1972–2000); Edward Yardeni et al., *Stock Market Indicators: S&P 500 Buybacks & Dividends*, YARDENI RES. 3 fig.1 (Apr. 17, 2019), http://www.yardeni.com/pub/buybackdiv.pdf (last visited Oct. 16, 2019) (showing the course of stock repurchases from 1999 to date).

[4] For the increase in the volume of share repurchases in the EU, see Henk von Eije & William L. Megginson, *Dividends and Share Repurchases in the European Union*, 89 J. FIN. ECON. 347, 356 tbl.2 (2008) (showing the increase in the number of share repurchases based on data over the period 1989–2005 in the EU); Mustafa Erdem Sakinç, *Share Repurchases in Europe: A Value Extraction Analysis* 13 tbl.5.1 (The Academic-Industry Res. Network, Working Paper No. 16, 2017), *available at* http://core.ac.uk/download/pdf/144862921.pdf (showing the course of share repurchases based on data from 2000 to 2015 in the EU in comparison with that in the US).

expressed dissenting opinions on share repurchases. While most American courts adopted the permissive approach that dominated state laws in the US,[5] the House of Lords in the United Kingdom (UK) took a prohibitive approach that later heavily influenced the relevant EU *acquis*.[6] The contrast between these two opposing approaches has been due to larger institutional differences shaped by idiosyncratic economic, historical, and political events in the US and the EU—the differences that caused purported benefits of share repurchases to become crucial in the US while urging courts and legislators to concentrate on potential drawbacks arising from the abuse of share repurchases in the EU. There are potential drawbacks associated with the abuse of share repurchases due to their inflationary effect on share prices as well as their disproportionate nature in distributing cash to shareholders. In addition to these shared features, OMRs stir more controversy than other repurchasing methods due to the non–obligatory nature of OMR announcements and the bargain nature of actual OMRs. These features of OMRs make them prone to manipulation and informed trading—the epitome of open market transactions.[7] On the other hand, economic changes in the second half of the twentieth century have brought liberal market economy and shareholder-oriented corporate model to the fore primarily in the US and elsewhere. In this setting, OMRs have multiple functions and have been (de)regulated through the adoption of a non-exclusive safe harbor rule by the SEC initially in the US.[8] The same changes have also caused EU Member States (and subsequently the EU) to divert from the prohibitive approach to share repurchases and substantially converge towards the permissive approach in the US. That is, legal capital rules including the rule on repurchases in the EU have been relaxed and a non-exclusive safe harbor rule applicable to OMRs that is essentially similar to that in the US has been

[5] *See infra* Chapter II.B.1.
[6] *See infra* Chapter III.B.1–2.
[7] *See infra* Chapter II.D.
[8] *See infra* Chapter II.B.4.

adopted in the EU. On the other hand, the OMR regulation in the EU still bears the traces of prohibitive approach by way of a more informative and timelier disclosure regime and additional trading restrictions. These regulatory differences seem to be the reflection of the underlying economic and corporate model; namely, the coordinated market economy and stakeholder-oriented corporate model that persist in most EU Member States.[9] Indeed, notwithstanding that this legal convergence was accompanied by a more rapid increase in the number of OMRs in the EU than in the US, the number of OMRs in the EU has been much lower than in the US. The less frequent use of OMRs supports the claim that EU Member States substantially persist in Continental European economic and corporate model, in which the purported benefits of OMRs have been less significant and the potential drawbacks arising from the abuse of OMRs have been less probable. However, the OMR regulation in the US, which has largely shaped the OMR regulation in the EU, seems to have failed in offering an effective regulation—the claim that has recently been expressed by a few SEC commissioners as well.[10] This dissertation identifies the problem as the overstatement of the purported benefits of OMRs as well as the understatement of potential drawbacks due to the abuse of OMRs, causing OMR regulations on both sides of the Atlantic to be shaped by these misstatements. Hence, the task here is to advise those charged with creating a safe and efficient market regulatory product by examining how it may be possible to maintain the purported benefits of OMRs while eliminating the potential drawbacks arising from the abuse of OMRs, in the light of lessons derived from the regulatory approaches of the US and the EU.[11]

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[9] *See infra* Chapter III.B.4–5.

[10] For positive opinions of the then Commissioner Robert Jackson Jr. and the incumbent Commissioner Hester Peirce on the possibility to revise the safe harbor rule, see Nominations of David J. Ryder, Hester M. Peirce, and Robert J. Jackson, Jr., *Hearing before the Subcomm. on Banking, Housing, and Urban Affairs*, 115th Cong. 34 (2017). For the then Commissioner Robert Jackson Jr.'s call for an open comment period on the safe harbor rule, see Robert J. Jackson Jr., *Speech at the Center for American Progress: Stock Buybacks and Corporate Cashouts* (June 11, 2018), http://www.sec.gov/news/speech/speech-jackson-061118.

[11] *See infra* Chapter IV.

B. Theoretical Framework

A corporation's ability to repurchase its own shares on the open market rests on the legal notion that a corporation has a separate legal personality that is distinct from its members so that it may theoretically repurchase its own shares on the open market, like its members. However, such purchases, just like trades of corporate insiders, would inherently create conflicts of interest and thereby need to be regulated. OMRs have primarily been regulated by an SEC rule in the US in 1982.[12] In effect, the rule seems to have deregulated OMRs.[13] This is because the vagueness arising from the absence of OMR-specific regulation might have posed the risk of violating anti–manipulation provisions[14] and the insider trading rule[15] and deterred management from executing OMRs. The OMR rule might have eliminated the deterrence effect of the absence of OMR-specific regulation by prescribing a safe harbor for managers free from the risk of violating anti–manipulation provisions and the insider trading rule, as long as they abide by trading conditions laid out in the rule.[16] Indeed, the number of OMRs has dramatically increased shortly after the adoption of the OMR rule.[17] As the adoption of the OMR rule coincided with the dramatic increase

[12] 17 C.F.R. § 240.10b-18 (2019) [hereinafter referred to as the Rule 10b-18].
[13] William Lazonick, *Stock Buybacks: From Retain-and-Reinvest to Downsize-and-Distribute*, CENTER FOR EFFECTIVE PUB. MGMT. BROOKINGS, 11 (Apr. 2015), http://www.brookings.edu/wp-content/uploads/2016/06/lazonick.pdf (stating that John Evans, the SEC commissioner at the time, expressed concern that Rule 10b-18 represented deregulation of buybacks that could result in market manipulation).
[14] Anti–manipulation provisions are stated in Section 9(a)(2) of the Securities Exchange Act of 1934. *See* 15 U.S.C. § 78i(a)(2) (2018).
[15] The insider trading rule was promulgated under Section 10(b) of the Securities Exchange Act of 1934. *See* 17 C.F.R. § 240.10b-5 (2019) [hereinafter referred to as the Rule 10b-5].
[16] Grullon & Michaely, *supra* note 3, *passim*.
[17] *Id.* at 1683 (finding that share repurchase activity experienced an upward structural shift after the adoption of the Rule 10b-18).

in the number of OMRs, it was argued that the rule encouraged corporations to execute OMRs, thereby precipitating an increase in the number of OMRs.[18]

Notwithstanding that the OMR rule might have paved the way for a dramatic increase in the number of OMRs, such an increase has mainly been the corollary of a market demand for OMRs. Market demand for OMRs has increased with the rise of liberal market economy and the shareholder-oriented corporate model.[19] This economic and corporate model arose following the resurgence of ideas on free market capitalism as of the 1970s, which is described as neoliberalism by this dissertation. Neoliberalism is generally associated with liberal economic policies including deregulation. Hence, a deregulation process, which also included the deregulation of OMRs, took place in the 1980s. Such deregulation process, in turn, reinforced the liberal market economy and the shareholder-oriented corporate model. Moreover, such process has increased financialization that is used to describe the development of financial capitalism (rather than industrial capitalism), in which the importance of financial sector and thereby debt-financing has increased. In this context, OMRs have become functional tools to enhance financialization, to allow corporations to operate in highly financialized markets, and above all, to maximize shareholder value by aligning interests of corporate stakeholders led by parties to agency relationship and thereby mitigating agency costs.[20]

On the other hand, there are potential drawbacks arising from the abuse of OMRs as OMRs are potentially manipulative open market transactions. First, OMR announcements may inflate share

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[18] *Id.* (arguing that the increase in the number of repurchases was enhanced by the introduction of the Rule 10b-18).
[19] *See infra* Chapter II.B.4.
[20] *See infra* Chapter II.C.

prices while failing to oblige corporations to actually repurchase their own shares. Second, actual OMRs inflate not only share prices but also earnings per share (EPS) whilst enabling corporations to repurchase their own shares at the market price and distributing cash to shareholders disproportionately.[21] Thus, OMRs enable those having inside (and superior) information to engage in informed trading at the expense of less-informed shareholders.[22] The potential alignment of interests between market actors holding informational advantages and having shorter-term financial interests might also cause corporations to squander cash via OMRs. Cash squandering via OMRs might result in underinvestment, which would harm corporations and thereby corporate stakeholders including long-term shareholders.[23] However, the potential drawbacks arising from the abuse of OMRs have been understated in the US for the same reasons that led to the overstatement of the purported benefits of OMRs.[24]

Rather, the potential drawbacks associated with share repurchases have historically far outweighed the purported benefits of share repurchases in the UK and in Continental European countries, which later gathered under the roof of the EU.[25] The skeptical approach of the House of Lords in the UK towards share repurchases has been welcomed by Continental European countries because such approach complies with the widely accepted economic and corporate practices in the EU. Accordingly, many EU Member States have been coordinated market economies and corporations

[21] *See infra* Chapter II.D.
[22] *See infra* Chapter II.D.1.
[23] *See infra* Chapter II.D.2.
[24] *See* Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Securities Act Release No. 6434, Exchange Act Release No. 19,244, Investment Company Act Release No. 12,823, 47 Fed. Reg. 53,333 at 1013 (adopted Nov. 26, 1982) [hereinafter referred to as 1982 Adopting Release] ('The Commission has recognized that issuer repurchase programs are seldom undertaken with improper intent, may frequently be of substantial economic benefit to investors').
[25] *See infra* Chapter III.B.1–2.

have been oriented towards stakeholders.[26] In this setting, corporate ownership has been more concentrated and the ownership and control has been less separated and their interests have inherently been more aligned than their US counterparts. Shareholders of these corporations provide patient capital rather than short-term capital and these corporations rely more on debt-financing rather than equity-financing. In this context, share repurchases have not been needed as much as in the US so that legal capital rules in the EU, one of the two pillars of which is capital maintenance that used to include an outright ban on share repurchases and restrict corporations from distributing cash to shareholders via share repurchases, largely remain intact, unlike in the US.[27]

The prohibitive approach against share repurchases as part of the legal capital rule would restrain corporations from distributing cash via share repurchases that would favour minority (outside) shareholders, who typically have shorter-term financial interests and exert control on corporations via exit. Rather, such approach would enable corporations to reinvest cash in positive net present value (NPV) investment projects. Reinvestment decisions would favour controlling (inside) shareholders, who typically make relational investing and expect return only when proceeds from investment projects are distributed in the form of dividends. The higher of level of long-term commitment would also facilitate dialogue among all corporate stakeholders, including but not limited to managers and shareholders, and enables them to have longer-term strategic interests and

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[26] For the definition of coordinated market economy and features of corporations operating therein and the comparison with liberal market economy, see PETER A. HALL & DAVID SOSKICE, *An Introduction to Varieties of Capitalism, in* VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE 1 (2001).
[27] Luca Enriques & Jonathan R. Macey, *Creditors versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 CORNELL L. REV. 1165 *passim* (2000).

to exert control through voice.[28] In this respect, the prohibitive approach has been in line with the corporate ownership structure in the EU. The strict regulation of share repurchases would also prevent corporations from reducing their capital to an amount that cannot satisfy creditors' claims. Hence, this approach would also facilitate debt as a bank-oriented mechanism of control that is reinforced by multiplex networks between corporations and strong representation rights to employees,[29] which are the prerequisites of a coordinated market economy.

The legal capital regime, however, has scaled back in the US. In the US, the protection of creditors as well as minority shareholders are predicated on the disclosure of information in general,[30] and also in the case of OMRs. The information disclosure regime seeks to protect creditors by providing them corporate financial information they can rely on when they enter into contracts with corporations. Information disclosure also aims to protect shareholders that hold minority stakes in corporations with dispersed ownership. Minority shareholders have financial interests and thereby favour strategies that would increase the market value of their shares and payouts. Minority shareholders also favour market liquidity so that they can sell their shares (and exit) in liquid markets when they dissent with managers.[31] In order to satisfy shareholders' financial interests and enable them to easily sell their shares and exit corporations, the US gives weight to policies led by OMRs, which do all at once by inflating share prices and EPS, distributing cash to shareholders, and increasing market liquidity.

[28] Ruth V. Aguilera & Gregory Jackson, *The Cross-National Diversity of Corporate Governance: Dimensions and Determinants*, 28 ACAD. MGMT. REV. 447, 450–54 (2003).
[29] *Id.* at 453–56.
[30] *Id.*
[31] *Id.*

This theoretical framework drawn up specific to OMRs once again demonstrates that the EU Member States (particularly Continental European countries) and the US have substantially different legal orders with distinct conceptual schemes based on different economic structures that are driven by different institutional and corporate domains and rooted in idiosyncratic historical and political events. However, countries have begun to interact and integrate with each other more intensely owing to the technological advances, which have generally gone parallel with Industrial Revolutions, particularly at the second half of the twentieth century—a process described as globalization by this dissertation. The globalization process has facilitated the liberalization process, and vice versa. A reflection of this interrelationship has been that globalization-induced competitive pressures led many nations to adopt liberal policies of the US. More specifically, global competitive pressures forced EU Member States to converge towards the economic and corporate system of the US based on the claim that the US economy performed better than their (East Asian) counterparts in the 1990s. Thus, globalization-induced liberalization, financialization, and shareholder capitalism took effect through privatizations of state-owned enterprises in the UK as of the 1980s,[32] and to a lesser extent, in Continental Europe as of the 1990s.[33] In line with this trend, each EU Member State respectively revised their company and market laws to protect minority shareholders as a prerequisite of shareholder-oriented corporate model and market-based financial system as part of liberal market economies. One of these measures has been the (de)regulation of OMRs in order to allow companies to execute OMRs that have a number of purported benefits for shareholder-oriented corporations operating in financialized liberal economies.

[32] BRIAN R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED (2008).

[33] For an in-depth discussion on the convergence of Continental European model towards Anglo-American model with an emphasis on Germany, see Marc Goergen et al., *Is the German System of Corporate Governance Converging Towards the Anglo American Model?*, 12 J. MGMT. & GOVERNANCE 37 (2008).

In order to harmonise company and market laws of EU Member States, the EU introduced a series of directives and regulations. Like in the US, one of the directives defined OMRs as potentially abusive transactions but exempted them from insider dealing and market manipulation allegations by providing a safe harbor for repurchasing corporations as long as they abide by trading conditions and restrictions laid out in the rule.[34] The nature and extent of the rule is very similar to that of the US, which has been in force since 1982. In line with the deregulation of the OMR rule, the legal capital regime, which included the outright ban on share repurchases, was also amended and relaxed in the EU towards the more relaxed regime in the US.[35] After all these amendments to the rules applicable to OMRs, certain EU companies began to more frequently execute OMRs upon the increasing demand of certain shareholders investing in EU companies through privatizations of state-owned enterprises.[36] Thus, the Americanization trend on the regulatory treatment of OMRs has been accompanied by the increasing cross-border interactions among shareholders, the quintessence of which is represented by pressures coming from US-style investors investing in large privatized EU companies, along with their highly financialized investment transactions including OMRs.

[34] *See infra* Chapter III.B.5.
[35] *See infra* Chapter III.B.4.
[36] von Eije & Megginson, *supra* note 4, at 349, 357 (finding that privatized corporations account for almost one-quarter of the total value of EU cash dividends and share repurchases, although they represent barely 2% of the number of listed firms, and, specifically, finding that the total value of share repurchases accounts for over half of the total value of cash dividends—although only one-fourth as many European companies repurchase shares as pay cash dividends—and the average amount repurchased by privatized corporations rose one-hundredfold from 1990 to 2005 while the average share repurchase amount for non–privatized companies increased elevenfold in the same period).

Notwithstanding that large-scale OMRs—though started much later in the EU than in the US—grew rapidly in the 1990s,[37] the number of OMRs and repurchasing companies in the EU have been lower than in the US.[38] The modesty in the number of OMRs in the EU seems to be mainly due to the persistence of most EU companies in the Continental European corporate model, in which shareholder-oriented and finance-driven corporate strategies have not gained much traction.[39] As a reflection of this persistence, the EU now has a seemingly less ineffective safe harbor rule than that in the US. Though the US can take lessons from the regulatory approach of the EU in this sense, this dissertation suggests that OMR regulations both in the US and the EU must be thoroughly reviewed and revised. This is because the ineffective regulatory approach of the US has largely been adopted by the EU, and this approach has opened the floodgates for corporations on both sides of the Atlantic to repurchase their own shares on the open market, to which the potential drawbacks arising from the abuse of OMRs have been concomitant.

C. Literature Review

The literature on share repurchases has been rich in that share repurchases include various methods employed by all types of corporations in purchasing their own shares. More specifically, there are many methods for public corporations to repurchase their own shares traded both on- and off-the market. These methods include but not limited to OMRs, repurchase tender offers (fixed-price and Dutch-auction tender offers), privately negotiated repurchases, and accelerated share repurchases.

[37] *Id.* at 348.
[38] Sakinç, *supra* note 4, at 12, 13 tbl.5.1.
[39] Goergen et al., *supra* note 33 (finding no clear signs of convergence in form, i.e. the main distinctive features of the Continental European corporate governance system have remained largely unaltered, whereas changes especially in the legal framework in the 2000s suggest a convergence in function, i.e. some governance mechanisms have effectively incorporated aims generally associated with the Anglo-American corporate governance model).

This dissertation focusses on the most common form of repurchases, namely, OMRs wherein a public corporation purchases its own shares on the open market.[40] While the number of OMRs has recently increased worldwide, the increase in the number of OMRs in the US was the first dramatic instance to be noted and the number of OMRs has been the highest since then. Hence, most studies on OMRs have been conducted in the US. These studies have sought to explain the dramatic increase in the number of OMRs and focussed on the purported benefits of OMRs in the US, which have been predominantly related to corporate governance and corporate finance. Thus, the vast majority of research on OMRs has been conducted by management, business, economy, and finance scholars in the US.

On the other hand, the failure of developed hypotheses and theories in fully explaining the increase in the number of OMRs has caused suspicion as to whether the dramatic increase in the number of OMRs has been partly due to the manipulative use of OMRs. OMRs are potentially manipulative financial tools that inflate share prices and EPS without creating value for corporations immediately after allowing corporations to repurchase their own shares at the market price. In the meantime, corporations end up distributing cash to shareholders via OMRs not on a pro rata basis. These factors enable those having inside or superior information to use their informational advantage to extract value at the expense of less-informed shareholders.[41] The potential alignment

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[40] Gustavo Grullon & David L. Ikenberry, *What Do We Know About Stock Repurchases?*, 13 J. APPLIED CORP. FIN., Spring 2000, at 31, 33–34 (finding that OMR programs comprised roughly 91% of the total value of all repurchase announcements over the period 1980–1999); William Lazonick, *Profits without Prosperity*, HARV. BUS. REV., Sept. 2014, at 46, 48 (stating that the 449 corporations in the S&P 500 index that were publicly listed from 2003 through 2012 bought back their own shares, almost all through purchases on the open market).

[41] For the ability of insiders to exploit OMRs, see Jesse M. Fried, *Open Market Repurchases: Signaling or Managerial Opportunism?,* 2 THEORETICAL INQUIRIES L. 865 (2001) (putting forward the managerial opportunism theory as an alternative to the signalling theory in explaining the wide use of OMRs and claiming that insiders seek to maximize their own wealth by adjusting their trades based around OMR announcements and actual OMRs). For the ability of certain outside shareholders to exploit OMRs, see Michael J. Brennan & Anjan V. Thakor, *Shareholder Preferences*

of interests of certain corporate actors to exploit OMRs may also cause corporations to execute excessive number of OMRs. Excessive use of OMRs would cause underinvestment and harm corporations and corporate stakeholders having long-term interests.[42]

From the legal standpoint, the high likelihood of exploitation of OMRs has been largely attributed to the ineffectiveness of rules applicable to OMRs in failing to prevent market manipulation and insider trading.[43] More specifically, the OMR rule is a non-exclusive safe harbor rule that cannot be directly enforceable, disclosure requirements are neither detailed nor timely, and the insider trading rule is not readily enforceable. The OMR Rule had taken its final form after the SEC introduced a series of amendments to the OMR Rule in 2003, the most crucial of which was the introduction of mandatory disclosure requirements.[44] Since then, economists and lawyers in the US have more intensively made policy proposals regarding OMRs.[45] These proposals could be categorized in two groups. The first group includes proactive political measures that might be taken by legislatures.[46] These measures seek to terminate, or significantly curb, the OMR activity of corporations and thereby eliminate adverse consequences of OMR-induced underinvestment on corporations and corporate stakeholders having long-term interests. The second group involves

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and Dividend Policy, 45 J. FIN. 993 (1990) (arguing that share repurchases are likely to be associated with the redistribution of wealth between more informed large shareholders and less-informed small shareholders).

[42] William Lazonick, *Why Executive Pay Matters to Innovation and Inequality, in* THE EMBEDDED FIRM: CORPORATE GOVERNANCE, LABOR, AND FINANCE CAPITALISM 413, 434–37 (Cynthia A. Williams & Peer Zumbansen eds., 2011) (defining OMRs as weapons of the shareholder value theory that extract value instead of creating value).

[43] Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 92 CAL. L. REV 1323 (2005) (claiming that rules and regulations on OMRs have been ineffective in preventing managers from using OMRs to transfer value via direct and indirect insider trading).

[44] Purchases of Certain Equity Securities by the Issuer and Others, Securities Act Release No. 8335, Exchange Act Release No. 48,766, Investment Company Act Release No. 26,252, 68 Fed. Reg. 64,952 (Nov. 17, 2003) [hereinafter referred to as 2003 Amending Release]. For further analysis on the amendments promulgated by the 2003 Amending Release, see *infra* Chapter II.B.5.

[45] For a more detailed examination of previous policy and regulatory proposals, see *infra* Chapter IV.B.

[46] *See infra* Chapter IV.B.1.

retroactive technical measures that could be implemented by market authorities.[47] These measures seek to inhibit those having inside or superior information from engaging in market manipulation and informed trading via OMRs at the expense of less-informed shareholders. The prevention of market manipulation and insider trading would eventually reduce the number of OMRs and alleviate the adverse consequences of OMR-induced underinvestment on corporations and corporate stakeholders having long-term interests.

While some of the previous studies examined the economic and legal aspect of OMRs and came up with various proposals referred to isolated regulatory methods applied by various countries, some other studies compared different regulatory frameworks on OMRs applied by various countries and their effects from different perspectives. However, none of these studies compared and contrasted the two leading and once opposing regulatory approaches to OMRs from a historical, legal, and economic perspective. Hence, as far as is known, this dissertation is the first that seeks to make policy proposals upon comparison of the regulatory approaches to OMRs in the US with those in the EU, namely, the two jurisdictions that have been subject to a number of bipolar typologies by comparative legal scholarship. A study at such lengths provides for a thorough comparison of differences and similarities between political, economic, and legal systems of the US and the EU and their repercussions specifically on the regulation and use of OMRs in due course. In this sense, this study chases down a substantial legal convergence and contributes to research in comparative corporate law and the convergence-divergence debate as well.[48]

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[47] *See infra* Chapter IV.B.2.
[48] *See infra* Chapter III.

The substantial convergence of the OMR regulation in the EU towards the regulatory framework in the US was followed by the increase in the number of OMRs, like in the US. This increase supports the claim that the particular regulatory framework has paved the way for the increase in the number of OMRs. However, more fundamentally, the comparative and comprehensive examination of the *rationale* for the legal convergence to the permissive regulatory approach and the increase in the number of OMRs indicates that they have been the corollary of the advent of the Anglo-American economic and corporate model in the EU. That is to say, the legal convergence on the more liberal rule and the increase in the use of the financial tool has been due to liberalization, financialization and shareholder capitalism in the EU.

On the other hand, this study also finds that the number of OMRs in the EU has been much lower than in the US and the OMR activity has been concentrated in the hands of large privatized companies that were formerly state-owned. These findings suggest that the purported benefits of OMRs have been much less significant for companies in the EU, which persist in the traditional economic and corporate model, than their counterparts in the US. Hence, this comprehensive comparative research concludes that the main explanation for the increase in the number of OMRs is embedded in the Anglo-American economic and corporate model. This finding enables this dissertation to test the hypotheses and theories developed to explain the increase in the number of OMRs mainly in the US. Ultimately, finding out the main motives for the increase in the number of OMRs enables this dissertation to come up with the most effective policy proposals that would eliminate the potential drawbacks arising from the abuse of OMRs while maintaining the purported benefits of OMRs.

D. Research Method

This study is an applied research paper and employs a mixed-research method. This dissertation has essentially been a legal research exercise, in that it critically examines regulation on OMRs and seeks to come up with an effective regulatory framework to eliminate the potential drawbacks arising from the abuse of OMRs while allowing corporations to continue to execute OMRs strictly for legitimate business purposes. To that end, this dissertation conducts policy-oriented research, particularly in Chapter IV, that addresses the question of how potential drawbacks associated with the abuse of OMRs can be mitigated. By doing so, this study uses the comparative research method, especially in Chapter III, in which the regulatory approach of the EU on OMRs has been compared to that of the US. Since legal systems and legal scholarship are typically nationally oriented, comparative legal scholarship must typically take national differences into consideration.[49] However, the comparison subject to this dissertation deserves greater scrutiny than a comparison between any legal systems with similar legal origins. Yet, this dissertation compares common law and civil law jurisdictions—substantially different legal orders with distinct conceptual schemes—based on different economic structures that are driven by different institutional domains and rooted in idiosyncratic historical and political events.[50]

Starting with a consideration of major differences that have been drawn between the US and the EU, this dissertation adopts a deductive approach. Accordingly, this dissertation examines the

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[49] *See* Geoffrey Wilson, *Comparative Legal Scholarship, in* RESEARCH METHODS FOR LAW 163 (Mike McConville & Wing Hong Chui eds., 2007).

[50] Mathias M. Siems, *Legal Origins: Reconciling Law & Finance and Comparative Law*, 52 MCGILL L.J. 55 (2007) (challenging studies that link their quantifiable results with the long-standing distinction between civil law and common law countries by disregarding their contexts).

repercussions of major differences between the legal and economic model of the US and the EU on OMRs.[51] The US, as the leading example of liberal market economies,[52] has market-based financial system and shareholder-oriented corporate model. In this context, the US provides liberal property rights to outside shareholders having minority stakes that facilitate market-oriented mechanisms of control.[53] This is because these shareholders generally pursue financial interests and exercise control through exit mechanism that is provided by market liquidity.[54] Liberal property rights thus protect these shareholders by requiring corporations to provide these shareholders with information necessary to make informed decisions.[55] Therefore, the main organizing principle of the OMR rule in the US has been the disclosure regime, whereas the rule itself allows corporations to execute OMRs in the hope of financially benefitting shareholders by enhancing share value and increasing market liquidity. Managers of US corporations, on the other hand, have greater autonomy and financial orientation mainly through stock-based compensation.[56] Consequently, these managers would not object to shareholder distributions via OMRs since OMRs, especially when combined with stock-based compensation, also benefit managers in many aspects.

Contrary to the US, most EU Member States, particularly Continental European countries, are characterized as coordinated market economies.[57] These countries rely on the coordination of formal institutions in order to regulate the market. These institutions include employees,

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[51] *See* Paul Chynoweth, *Legal Research, in* ADVANCED RESEARCH METHODS IN THE BUILT ENVIRONMENT 28 (Andrew Knight & Les Ruddock eds., 2008).
[52] HALL & SOSKICE, *supra* note 26, at 19.
[53] Aguilera & Jackson, *supra* note 28, at 450–54.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] HALL & SOSKICE, *supra* note 26, at 19–21.

corporations and banks that lead to the formation of large controlling shareholders having strategic interests. In this setting, banks have been major sources of capital and exercise control over corporations through debt and commitment; corporations have ownership stakes one another and pursue strategic interests; and, employees have strong representation rights and participate in corporate decision making process through internal channels and codetermine management actions.[58] These interest groups would not want corporate capital to be spent on shareholder distributions in any form including share repurchases. More importantly, controlling shareholders other than the institutions (mostly families) make relational investing and have strategic interests as well. Hence, these shareholders would not need distributions in the form of share repurchases and market liquidity increased by share repurchases. Similarly, EU companies are managed with either large shareholders themselves or salaried managers having greater commitment and functional orientation.[59] All these interest groups would prefer to reinvest cash instead of distributing excess cash to shareholders through share repurchases led by OMRs. Hence, in order to limit such distributions and maintain legal capital, share repurchases have historically been strictly regulated as part of the legal capital rule.[60]

Despite all these institutional differences, the comparative method enables this study to detect a high degree of convergence with respect to the regulation of OMRs, whereas convergence at institutional level has been much more limited in that EU Member States and companies largely persist in the traditional economic and corporate model. Thus, path dependence claims hold sway in that national differences continue to exist due to institutional factors embedded in economic,

[58] Aguilera & Jackson, *supra* note 28, at 449–57.
[59] *Id.* at 457–59.
[60] Enriques & Macey, *supra* note 27, at 1168–69, 1202.

legal and corporate systems.[61] Recalling that this dissertation has primarily concerned itself with legal research, primary sources have been drawn from case law and black-letter law.[62] Under the case law limb, this study uses the doctrinal research method to understand the historical origins of the two opposing schools of thought with respect to share repurchases, namely the American Rule and the British Rule. Under the legislation limb, this dissertation examines the sets of rules that constructed the framework for OMRs in the US and the EU. The historic differences between OMR regulations in the US and the EU, however, are not only in their content, but also in the details of why, how and by whom they were enacted and implemented and what sanctions they imposed.[63] Apart from each securities exchange as well as company laws at state and country levels, the Securities and Exchange Commission (SEC) solely regulates and assumes the oversight of OMRs in the US through its certain rules, whereas the European Commission (EC) and the European Securities Market Authority (ESMA) mainly regulate OMRs through regulations and national market authorities implement regulations in EU Member States.

Most sources this dissertation uses have been secondary, as this dissertation is built upon previous research in law and economics. More specifically, this dissertation relies on legal and economic literature because it has been a legal research, the subject of which has essentially been a financial tool purportedly providing various economic benefits to corporations and their stakeholders. Hence, notwithstanding that this dissertation has been constituted by qualitative research rather

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[61] For an in-depth discussion on convergence-divergence debate with regard to corporate governance models, see JOSEPH A., MCCAHERY ET AL., CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY (2002); JEFFREY N. GORDON & MARK J. ROE, CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (2004).
[62] *See generally* Shane Kilcommins, *Doctrinal Legal Method (Black-Letterism): Assumptions, Commitments and Shortcomings, in* LEGAL RESEARCH METHODS: PRINCIPLES AND PRACTICALITIES 18 (Laura Cahillane & Jennifer Schweppe eds., 2016).
[63] *See generally* Philip Handler, *Legal History, in* RESEARCH METHODS IN LAW 85 (Dawn Watkins & Mandy Burton eds., 2013).

than quantitative research, a significant amount of the economic literature that this dissertation relies on contains quantitative research.[64] These figures include, but are not limited to, the ratio of share repurchases to dividends and the volume of shares repurchased in a certain time period under jurisdictions that are subject to comparison. As the last two research methods indicate, a part of this dissertation involves an interdisciplinary/socio-legal research approach, namely, of law and economics as social sciences.[65] This dissertation also draws upon other interdisciplinary work in psychology, history, and politics in demonstrating why OMRs need further regulation and how OMRs need to be regulated.

E. Research Limitations

Public corporations may repurchase their own shares through on- and off-market transactions. These transactions include OMRs, repurchase tender offers (fixed-price and Dutch auction), privately negotiated repurchases, and accelerated share repurchases. This dissertation concentrates on on-market transactions, namely OMRs that have been the most common form of share repurchases.[66] However, there are also different methods for a corporation to repurchase its own shares on the open market at the market price. These methods include traditional OMRs and pre–

[64] *See generally* Mathias M. Siems & Simon Deakin, *Comparative Law and Finance: Past, Present and Future Research*, 166 J. INSTITUTIONAL & THEORETICAL ECON. 120 (2010).
[65] *Id.*
[66] *See* sources cited *supra* note 40 and accompanying text.

set OMRs.[67] This dissertation focusses on traditional OMRs because traditional OMRs have been much more common and problematic than pre–set OMRs.[68] However, pre–set OMRs may also cause some of the problems inherent in traditional OMRs.[69] Thus, market regulators must also pay closer attention to pre–set OMRs once they consider regulating traditional OMRs.

Since this dissertation focusses on traditional OMRs, it principally centers upon the regulation of traditional OMRs in the US and the EU. Hence, this dissertation covers only OMR-related legal and economic developments that have emerged in these jurisdictions from the 1980s until the 2020s. Considering the period covered, this dissertation excludes temporary effects of COVID-19 pandemic on corporate policies including OMRs. This dissertation also excludes the withdrawal

[67] For pre–set OMRs in the US, see 17 C.F.R. § 240.10b5-1 (2019) [hereinafter referred to as Rule 10b5-1]. The rule requires a corporation to establish trading plans in its window period (when they possess no material non–public information) to provide details of repurchases to a broker to effect repurchases at a later date in order to allow the corporation to repurchase its own shares even when the corporation later possesses material non–public information, and thereby the rule establishes an affirmative defense to a potential claim that the was aware of material non–public information when any such repurchases are then effected. For pre–set OMRs in the EU, see Commission Delegated Regulation (EU) 2016/1052, of 8 Mar. 2016 Supplementing Regulation (EU) No 596/2014 of the European Parliament and of the Council with regard to Regulatory Technical Standards for the Conditions Applicable to Buy-Back Programmes and Stabilisation Measures, art. 4(2), 2016 O.J. (L 173) 34, 38 [hereinafter referred to as Commission Delegated Regulation 2016/1052]. The article states that trading restrictions applicable to corporations executing traditional OMRs are not applicable when the corporation has in place a time-scheduled buy-back program where the dates and volume of shares to be traded during the time period of the program are set out at the time of the public disclosure of the buy-back program, and when the buy-back program is lead-managed by an investment firm or a credit institution, which makes its trading decisions concerning the timing of the purchases of shares of a corporation independently of the corporation.

[68] Alice A. Bonaimé et al., *Payout Policy Tradeoffs and the Rise of 10b5-1 Preset Repurchase Plans* (Mar. 1, 2019), available at http://ssrn.com/abstract=2557005 (finding that the use of Rule 10b5-1 has increased significantly in that more than one quarter of all repurchase announcements include a Rule 10b5-1 component).

[69] Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913 (2007) (citing those who have suggested that the Rule 10b5-1 is being misused in that executives establish trading plans under the rule, know when trades will occur under these plans and then, in order to maximize their profits when trades are made, delay or accelerate disclosure of corporate news that would affect the stock price); Lazonick, *supra* note 13, at 8–9 (noting that managers are able to time their option exercises and stock sales even with pre–set OMRs under Rule 10b5-1). *See also* Bonaimé et al., *supra* note 68 (finding that repurchase plans under the Rule 10b5-1 signal a greater commitment with higher completion rates than traditional OMRs, which curbs their flexibility but increases market reaction to announcements of these plans). The higher market reaction to OMR announcements increase share prices more and gives more room for managers to adjust their trades in a way to reap profits.

of the UK from the EU, which has been effective as of January 31, 2020, and regards the UK as one of the EU Member States. The UK has been the crucial constituent of this dissertation in that the UK has been the leading liberal market economy that was subject to the EU *acquis* and led the harmonization of EU company and securities laws with its liberal rules.

On the other hand, this study seeks to comprehend the basics of the historical differences between the initial regulatory approaches of the US and the EU on share repurchases and the transformation of rules applicable to share repurchases, and OMRs in particular. For this purpose, this research exceptionally refers back to seminal court decisions given by British and American courts on share repurchases in the nineteenth century and reviews historical, political, economic and legal events that have directly or indirectly shaped OMR regulations and practices on both sides of the Atlantic throughout the twentieth century.

Although the research that informs this dissertation was conducted in Canada, this dissertation uses the comparative method for the most part to compare the legal, economic, and organizational aspects of OMRs in the US with those in the EU. Yet, jurisdictions other than the US and the EU fall within, or at least show resemblance to, either of the systems. This is because the US and the EU represent leading examples of jurisdictions having different and mostly opposing legal, economic and corporate models that have been subject to bipolar typologies.[70] In this context, Canada is categorized as a liberal market economy,[71] while resembling the UK in terms of having similarities particularly with the Continental European corporate model.

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[70] For a general comparison on political economic systems and corporations operating in these systems, see HALL & SOSKICE, *supra* note 26, at 20. For a more specific comparison on corporate models, see Aguilera & Jackson, *supra* note 26, 447–65.
[71] HALL & SOSKICE, *supra* note 26, at 19.

Indeed, Canada has been one of the first countries to follow in the footsteps of the US in regulating OMRs.[72] However, the legal framework on OMRs, which has been largely drawn under the auspices of Toronto Stock Exchange,[73] includes a prescriptive rule with more rigorous disclosure regime and substantive conditions.[74] In other words, Toronto Stock Exchange prescribes a stricter regulatory framework than the safe harbor rules in the US and the EU. Hence, this dissertation—though not directly including Canada in its comparison—necessarily makes direct and indirect references to regulatory solutions that exist in Canada's leading securities market.

F. Main Argument and Dissertation Outline

This dissertation argues that the regulatory framework on OMRs in the US has been inefficient in eliminating drawbacks arising from the abuse of OMRs, and this inefficient regulatory framework has also been largely adopted by the EU. Thus, this dissertation suggests that the regulation on OMRs must be revised in both jurisdictions based on lessons drawn from the comparison between these two jurisdictions. For this purpose, this dissertation consists of five chapters. Following this

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[72] David Ikenberry et al., *Stock Repurchases in Canada: Performance and Strategic Trading*, 55 J. FIN. 2373, 2374 (2000).

[73] It should be noted that there has been no single national market regulator in Canada, and OMRs, which are referred to as Normal Course Issuer Bids in Canada, are subject to general bylaws of each exchange in Canada. Since the largest and most representative stock exchange in Canada has been the Toronto Stock Exchange, this dissertation refers to Toronto Stock Exchange Rules and Regulations that are applicable to OMRs.

[74] *See* Toronto Stock Exchange Company Manual, §§ 628–629 (2019). Like the previously proposed Rule 13e-2 in the US and unlike the safe harbor rules in the US and the EU, the rule imposes substantive restrictions to corporations in that corporations, whose securities are traded in Toronto Stock Exchange, can only purchase up to 2% of a class of its own shares in a given 30-day period up to a maximum of the greater of 5% of the outstanding shares or 10% of the public float over a 12-month period. Other considerable regulatory differences have been that Toronto Stock Exchange requires corporations to receive approval from the exchange before initiating an OMR program, to report their trading activity on a monthly basis within 10 days of the end of each month. Toronto Stock Exchange imposes explicit trading restrictions for insiders who wish to trade during the period when a buyback program is under way.

Introduction Chapter, Chapter II comprises of five parts. Following the Introduction Part, Part B overviews the historical development of rules applicable to OMRs in order to demonstrate how the current OMR regulation has been formed. Hence, Part B suggests that deregulation policy as part of neoliberalism caused the formation of the inefficient regulatory framework on OMRs in the US, while the predominant corporate theory, in which OMRs have been more functional, has also been shaped by neoliberalism. This theory describes a shareholder-oriented corporate model based on the assumption that corporate interests are best aligned with those of shareholders so that managers should pursue policies to distribute excess cash to shareholders and increase share value in the shortest-term possible.

Consequently, the number of OMRs has dramatically increased in the US and the dramatic increase has been due to multiple functions of OMRs that are beneficial for increasingly shareholder-oriented corporations operating in the increasingly financialized markets. The functions of OMRs include their relative advantage over dividends in more efficiently distributing cash to shareholders, their interrelationship with respect to executive compensation, their functions in corporate finance, their role as defense mechanisms within the market for corporate control, and their function in supplying shares for ESOPs. Hence, Part C exhaustively enumerates these purported benefits of OMRs in this setting and reviews them in order to determine whether and to what extent OMRs have been beneficial for corporations and their stakeholders. Part C acknowledges that OMRs have multiple functions but also finds that some of these functions could be performed by alternative methods and some of them could be beneficial only when OMRs are executed in certain circumstances. Hence, Part C concludes that no function alone could fully explain the dramatic increase in the number of OMRs, whereas the multifunctionality of OMRs explains a substantial part, but not all, of the increase in the number of OMRs.

Part D argues that this increase could be fully explained only when considering the possibility that OMRs could be exploited by managers and active institutional shareholders that have either inside or superior information. Yet, OMRs are potentially manipulative transactions. This is because OMR announcements do not oblige corporations to repurchase their own shares and allow corporations to engage in false signalling, whereas actual OMRs inflate share prices after enabling corporations to repurchase their own shares on the open market at the market price in a flexible manner while distributing cash to shareholders disproportionately. Building upon this argument, Part D further asserts that interests of managers have been aligned with interests of active institutional shareholders, particularly short-term shareholder activists, with respect to OMRs. While an alignment of interest between managers and shareholders would seem desirable from the point of view of shareholder value theory, such alignment occurs between those that are supposed to counterbalance each other with respect to business decisions including OMRs. Consequently, this alignment of interest causes these corporate actors to implicitly collaborate to exploit OMRs to maximize their short-term financial interests that would likely result in an uncontrolled increase in the number of OMRs. For this purpose, Part D points out potential drawbacks arising from the abuse of OMRs on less-informed shareholders through harming markets as well as corporate stakeholders having long-term interests through harming corporations. Part D thus examines how, to what extent, and why the OMR regulation in the US fails to eliminate the potential drawbacks arising from the abuse of OMRs. Chapter II ends with the Conclusion Part.

As Chapter II concludes with the demonstration that the liberal regulatory framework on OMRs has been inefficient in eliminating potential drawbacks arising from the abuse of OMRs, Chapter III examines how the EU regulates share repurchases and particularly OMRs in comparison with the US. For this purpose, Chapter III consists of five parts. Following the Introduction Part, Part B reviews the historical development of rules and regulations on OMRs in comparison with the US in order to demonstrate to what extent and why EU laws on share repurchases and OMRs were historically different from those in the US, and to what extent and why the OMR regulation in the EU has converged to that in the US in due course. Part B finds that the EU regulatory framework on share repurchases and OMRs, which was once substantially different from that in the US, has been relaxed and thereby substantially converged towards the regulatory framework in the US. More specifically, this part determines that a number of EU Member States and later the European Commission have regulated OMRs through a safe harbor rule that is essentially similar to that in the US except for a few regulatory technical differences that make OMR regulation in the EU prima facie stricter than that in the US. Part B suggests that such substantial legal convergence has been the corollary of the convergence of the economic and corporate model in the EU towards the US, but continuing differences indicate that the convergence at the institutional level has only been partial.

Hence, Part C examines the extent of the convergence of the Continental European economic and corporate model towards the Anglo-American model based on the use of OMRs. For this purpose, Part C examines purported benefits of OMRs in the EU in comparison with those in the US, which appear as prime reasons for an even more rapid increase in the number of OMRs in the EU than in the US. One of the few regulatory technical differences of the OMR regulation in the EU has been that it exclusively states for what purposes a company can execute OMRs in order to benefit from the protection offered by the safe harbor rule. However, such regulatory approach does not prohibit companies from executing OMRs for purposes other than those specified in the rule. Companies executing OMRs for any of these purposes may easily conceal them behind the business purposes specified in the regulation. Therefore, Part C initially contextualizes and examines the specified purposes and later unspecified purposes to determine to what extent EU companies would execute OMRs for these purposes. Part C finds that the safe harbor rule technically allows EU companies to execute OMRs for almost all the purposes available in the US, but rests on previous quantitative research that has found that most EU companies do not execute OMRs as extensive as their US counterparts. This part conjectures that the limited number of OMRs has mainly been due to the persisting institutional differences between the US and the EU.

Part D tests whether and to what extent the potential drawbacks arising from the abuse of OMRs in the context of the US are likely to occur in the EU, by comparing legal and institutional factors at play in the EU with those of the US. Part D suggests that the substantial convergence of the OMR Regulation in the EU towards the inefficient OMR Rule in the US would technically allow managers and active institutional shareholders to exploit OMRs and cause the potential drawbacks associated with the abuse of OMRs in the US to arise in the EU as well. On the other hand, this part argues that the structure-driven path dependence of EU Member States and most EU companies as well as the rule-driven path dependence with respect to OMRs in the form of regulatory technical differences, which have been the corollary of the structural path dependence, prevent managers and active institutional shareholders in most EU companies from exploiting OMRs. Consequently, the number of OMRs in the EU has not been as dramatic as in the US so that the potential drawbacks due to OMR-induced underinvestment would be expected to be less severe in the EU than in the US. Conclusion Part ensues.

In the light of these comparative findings, this dissertation conjectures that a part of the increase in the number of OMRs in the US could be attributed to the ability of managers and active institutional shareholders to exploit OMRs and the alignment of interests of managers and short-term shareholder activists with respect to OMRs. Thus, eliminating the ability of these interest groups to exploit OMRs would prevent not only market abuse but also underinvestment induced by the excessive use of OMRs. However, this dissertation also suggests that current OMR regulation in the US have been ineffective in eliminating the potential of market manipulation and informed trading, and that the OMR regulation in the EU—though as not much as in the US—has also been ineffective as it has substantially converged towards the regulation in the US, except for a few technical differences.

In this context, Chapter IV makes regulatory proposals for market authorities on both sides of the Atlantic, with emphasis on the SEC, to revise their rules and regulations applicable to OMRs. For this purpose, Chapter IV relies on the findings of the comparison of the regulatory technical differences between the US and the EU as well as previously proposed policies and regulations. Chapter IV contains six parts. Following the Introduction Part, Part B critically reviews the policy and regulatory proposals previously raised in the US. Part C comes up with a twofold policy proposal for an effective regulatory framework both in the US and the EU mainly by recommending the US to look to technical features of the EU regulatory framework on OMRs. In this context, Part C recommends US and EU market authorities to enhance their existing disclosure regimes and oversight mechanisms. Part D offers a variety of proposals that would complement proposed regulatory technical amendments. Part E includes a cost-benefit analysis on all the proposals made in this dissertation that demonstrates that potential costs associated with these proposals are not too prohibitive to prevent corporate insiders from executing OMRs for legitimate purposes. Rather, this part argues that additional costs are expected to reduce the potential of market manipulation and informed trading by deterring corporate insiders from excessively executing OMRs, which would in turn alleviate the adverse consequences of OMR-induced underinvestment.

CHAPTER II. REASSESSMENT OF PURPORTED BENEFITS OF OPEN MARKET REPURCHASES AND POTENTIAL DRAWBACKS ARISING FROM THE ABUSE OF OPEN MARKET REPURCHASES IN THE US: A LAW AND ECONOMICS PERSPECTIVE

A. Introduction

The number of OMRs has dramatically increased in the US since the 1980s to such an extent that the dollar amount spent on share repurchase programs by US corporations has grown from around (inflation-adjusted) $6 billion in 1980 to $875 billion in 2018 (see Appendix 1). Notwithstanding that US corporations have historically been allowed to repurchase their own shares,[75] the beginning of the increase coincided with the initial (de)regulation of OMRs in 1982. The rule provides a safe harbor for corporations and their insiders to execute OMRs without fear of being subject to allegations of market manipulation and insider trading.[76] In effect, the adoption of the safe harbor rule on OMRs has been the corollary of deregulation caused by the emergence of neoliberalism. Neoliberalism has also brought along the shareholder-oriented corporate model, in which share repurchases, and particularly OMRs, serve many purposes. Indeed, while the safe harbor rule might have paved the way for the increase in the number of OMRs,[77] the increase has essentially been linked to the functions of share OMRs that may benefit shareholder-oriented corporations operating in liberal markets.[78]

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[75] *See infra* Part B.1–2.
[76] *See infra* Part B.4.
[77] *See supra* note 18 and the accompanying text.
[78] *See infra* Part D.

On the other hand, there are potential drawbacks arising from the abuse of OMRs. Drawbacks may occur due to manipulative nature of OMR announcements and actual OMRs. OMR announcements are potentially manipulative because they may inflate share prices, but they do not oblige corporations to actually repurchase their own shares. Actual OMRs are also potentially manipulative in that they increase share prices and EPS shortly after enabling corporations to repurchase their own shares at the market price. By doing so, corporations end up distributing cash to shareholders not on a pro rata basis. In other words, the combination of the inflationary and non–obligatory nature of OMR announcements and the inflationary, bargain, and disproportionate nature of actual OMRs makes OMRs potentially manipulative open market transactions.[79]

For these reasons, in the absence of effective legal measures, OMRs may be exploited by those having inside or superior information at the expense of less-informed shareholders, which would ultimately harm markets.[80] The ability of those having inside or superior information to exploit OMRs may enable them to align their interests on OMRs that might cause corporations to excessively execute OMRs.[81] Excessive use of OMRs could harm corporations and corporate stakeholders having long-term interests. Therefore, US market regulators, particularly the SEC, must eliminate the potential for market manipulation and insider trading while allowing corporations to execute OMRs for legitimate purposes.

[79] *See infra* Part E.
[80] *See infra* Part E.1.
[81] *See infra* Part E.2.

For this purpose, Chapter II comprises five parts. This Introduction Part is followed by Part B, which overviews the rules and regulations on OMRs in the US in historical context. Within the relatively liberal regulatory framework, Part C goes on to comprehensively re–examine the purported benefits of OMRs to check whether, to what extent and to whom OMRs are beneficial. Part D points out potential drawbacks arising from the abuse of OMRs to comprehend whether and whom such abuses may harm. This part also answers the questions of whether and to what extent current rules and regulations on OMRs in the US have been able to eliminate these drawbacks, and if not, why current rules and regulations on OMRs fail to effectively eliminate these potential drawbacks. This chapter concludes with Part E.

B. An Overview of the Development of Rules Applicable to OMRs in the US

OMRs have been subject to rules contained in corporation laws at the state level, securities laws at the federal level as well as certain requirements of each market facility. Repurchasing rules in corporation laws apply to all types of share repurchases including OMRs. The introduction of these rules dates back to the early nineteenth century when American courts began to investigate disputes arising from a corporation's purchase of its own shares. Securities laws on a public corporation's ability to repurchase their own shares have their origins in the Securities Exchange Act of 1934, whereas the rule specific to OMRs dates back to 1982. However, as this part suggests, the end-product of this protracted regulatory process has resulted in an ineffective legal framework on OMRs. Hence, this part traces the legal background of OMRs in the US and discusses contributing factors that caused the formation of the ineffective legal framework in five sections.

The first section analyzes case law on share repurchases that has formed the rule, which is colloquially known as the American Rule, and factors that affected its formation. The second section moves on to review initial legislative acts on market repurchases under the Securities Exchange Act of 1934. The third section reviews proposed rules on OMRs with particular emphasis given to factors that urged market regulators to consider regulating OMRs. The fourth section thoroughly examines the end-product of regulatory efforts, namely, Rule 10b-18, that substantially differs from its predecessors and remained in line with the permissive approach to the American Rule by prescribing a safe harbor rule. This part concludes with the section that reviews amendments to the safe harbor rule, particularly the introduction of mandatory disclosure requirement, in the wake of the corporate governance crisis in the beginning of 2000s.

1. The American Rule on Share Repurchases

Most early corporations in the US were formed as registered corporations rather than charter corporations owing to the late economic development of the US compared to that of Europe.[82] Registered corporations have their own personality distinct from their shareholders upon registration.[83] The concept of separate legal personality accompanies the doctrine of limited liability. The doctrine of limited liability limits shareholders' liability arising from corporate debts up to the value of their shares. This limitation inhibits the ability of creditors of an insolvent corporation to hold the corporation's shareholders liable for corporate debts. In order to protect

[82] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 10 (1933) (stating that the joint stock trading companies, which were formed as charter corporations that built up the merchant empires of England and Holland in the seventeenth century, entered into the field of industry in the US only in the nineteenth century and mainly to be used for undertakings involving a direct public interest).
[83] *See generally* Paddy Ireland, *Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Corporate Personality*, 17 J. LEGAL HIST., no.1, 1996, at 41.

creditors, corporations are required to disclose financial information and be bound by contracts they conclude with voluntary creditors.[84] The *rationale* is that voluntary creditors are able to take care of themselves by contract as long as corporations publish their financial statements truthfully.[85]

Nevertheless, corporate executives may distort financial statements that would mislead voluntary creditors before the contract date and/or squander cash and reduce cash cushion after the contract date by means of financial tools including share repurchases. These acts that are detrimental to voluntary creditors could be avoided by statutory measures in advance. However, the political structure of the US—comprising of states that have their own law and order—causes regulatory competition amongst states that results in the adoption of liberal rules favoring corporate executives. Yet, state authorities seek to build more flexible case law in order to attract corporations to domicile in their jurisdictions.[86] This approach has also been reflected in case of share repurchases and the courts in most states adopted a permissive approach and allowed corporations to repurchase their own shares for legitimate business purposes.[87] Consequently, instead of proactive statutory measures, states typically employ minimum statutory standards on their corporation laws and relies more on the law of fraudulent transfers for the protection of creditors.

[84] JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY, WITH SOME OF THEIR APPLICATIONS TO SOCIAL PHILOSOPHY 478–99 (1852).
[85] *Id.*
[86] For this particular political and legal structure and its effects on corporate law, see generally William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).
[87] E. Merrick Dodd, Jr., *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law,* 89 U. PA. L. REV. & AM. L. REG. 697, 697 (1941).

The earliest case on share repurchases appears to date back to a verdict given by a Georgia court, in which a bank wished to invest its capital surplus to purchase of its own shares, and thereafter aimed to gain profits by selling these repurchased shares.[88] However, the most influential decision was given by an Ohio court that dealt with the acceptance by a corporation of own shares in the settlement of debts owing to it, and allowing the debtor corporation to purchase its own shares for this reason.[89] The *rationale* was that there is no reason to prevent corporations from purchasing their own shares in the absence of any provisions prohibiting such purchase, and provided that such purchase would be in good faith and without injury to its creditors and stockholders. The vast majority of subsequent decisions were in line with this judgment, which allowed corporations to repurchase their own shares. However, the cornerstone decision was made in 1858 when the New York Court of Appeals reiterated the perspective that no common law principle is known to forbid a corporation from buying its own shares.[90]

While this judgment largely underpins the American Rule favouring the permissive view that the purchase by a corporation of its own shares is a legitimate corporate act,[91] most states adopted the

[88] Hartridge v. Rockwell R. M. Charlton 260 (Ga. Super. Ct. 1828) (The Georgia court claimed that two different interest groups can challenge against such transaction: creditors and shareholders. First, the court assessed creditors' claim that such transaction could be detrimental to the capital of the corporation, but the court held that the corporation had in turn shares in its treasury as a result of the repurchasing, and that it would not be prejudicial to creditors' rights. Second, the court argued that shareholders might claim that managers might entrench themselves at the expense of shareholders by eliminating possible threats of block holders. However, the court ruled that it was not in the position to properly inquire into managers' motives behind the purchase. This ruling is crucial in that the court agreed that shareholders have no right of pre–emption in treasury stock. However, although this ruling was the earliest square decision and in line with the prevailing view of the US courts on repurchases, subsequent cases have not relied on this decision due to disagreement on the reasoning of the Georgia court for the rejection of creditors' claims. This judgment was heavily criticized because treasury shares, which creditors may look to, are worthless to creditors of an insolvent corporation).

[89] Taylor v. The Miami Exporting Co. 6 Ohio 176 (1833).

[90] City Bank of Columbia v. Bruce & Fox, 17 N. Y. 507 (1858).

[91] Converse views were expressed even after the influential decision of New York Court of Appeals, whereas the vast majority of the subsequent case law adopted the permissive approach that corporation's use of its capital for the

American Rule into their corporate statutes. Such wide adoption has been part of the regulatory competition amongst states, which resulted in the triumph of the State of Delaware.[92] The apparent success of Delaware in liberalizing corporation laws was reflected into the Delaware General Corporation Law, which explicitly made share repurchases available for corporate use with the amendment in 1917.[93] The Delaware General Corporation Law now states that every corporation may purchase its own shares, unless the capital of the corporation is impaired or such purchase would cause any impairment of the capital of the corporation, except that a corporation may only do so if repurchased shares will be retired upon their acquisition and the capital of the corporation reduced.[94]

2. Initial Legislative Acts on Market Repurchases

Registered corporations with limited liability further expanded owing to the Second Industrial Revolution.[95] Expanding corporations were formed as cartels and monopolies and later as

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purchase of its own shares is not improper. The permissive approach might have also encouraged corporations to repurchase their own shares even under conditions which courts would not favor due to the reason of capital impairment and thus detrimental to the rights of creditors as well as shareholders. On the other hand, even the courts that adopted the permissive view acted with suspicion to cases, in which creditors' interests interfered with the interests of shareholders, the shares of whom were promised to be repurchased. In these cases, share repurchases were investigated whether they were funded out of capital or surplus, whether they impaired capital or whether they were executed when the corporation was insolvent, and whether the corporation became insolvent before or after the repurchase (promise) or the credit.

[92] More than 60 percent of the Fortune 500 corporations incorporated in the State of Delaware. Further information, see DELAWARE.GOV, *Why Businesses Choose Delaware*, http://corplaw.delaware.gov/why-businesses-choose-delaware (last visited Oct. 16, 2019).

[93] Earlier forms of the Delaware General Corporation Law did not prohibit share repurchases and implied in various provisions that corporations could repurchase their own shares.

[94] DEL. CODE. tit. 8, § 160(a)(1) (2019).

[95] While registered corporations with limited liability was initially expanded by the First Industrial Revolution in the period 1760–1840, the Second Industrial Revolution, which includes technological advances that span from 1870 to the start of the World War I in 1914, accelerated their expansion process.

oligopolies that ultimately undermined the market competition—a crucial element of the classical economic theory.[96] While the formation of trusts was sought to be prevented via antitrust laws, markets were underregulated.[97] Underregulated markets caused shareholders, the number of which dramatically increased in parallel with industrialization in the 1920s, to trade and make quick profits via speculation in underregulated stock markets. Speculative trading eventually contributed to the Stock Market Crash of 1929. In response to the shareholders' speculative activities, the Securities Act of 1933 for primary markets and the Securities Exchange Act of 1934 for secondary markets were enacted. The Securities Exchange Act of 1934 contained initial legislative acts that have had an effect on a public corporation's purchase of its own shares on the market. Specifically, Sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934 addressed manipulative and speculative acts.[98] The latter section implicitly authorized the SEC to set a framework for insider trades through OMRs. In line with this authorization, the SEC adopted the Rule 10b-5 prohibiting fraud by any person including individuals and corporations in connection with the purchase of securities in 1942.[99]

3. Regulatory Proposals on OMRs

After the Stock Market Crash of 1929, other remarkable pieces of legislation were also enacted to

[96] GAUGHAN, PATRICK A., MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 42 (2015).
[97] *Id.* at 44–50 (These antitrust laws are the Sherman Act of 1890, the objective of which was to deal with cartels and monopolies but initiated horizontal mergers, and the Clayton Act of 1914, the objective of which was to fill the loopholes of the Sherman Act of 1890 but resulted in the formation of vertical mergers. Lastly, the Celler-Kefauver Act of 1950 complemented the two previous antitrust laws by filtering both horizontal and vertical mergers but resulted in the formation of conglomerates).
[98] *See* 15 U.S.C. §§ 78i(a)(2), 78j(b) (2018).
[99] *See* Exchange Act Release No. 3230 (May 21, 1942). For an earlier recommendation of a statutory intervention on a corporation's ability to purchase its own shares in the wake of the Great Depression, see Irving J. Levy, *Purchase by a Corporation of Its Own Stock,* 15 MINN. L. REV. 1 (1930).

restore investor confidence to capital markets.[100] These acts increased market liquidity by enabling investors, who were tempted by market performance, to invest in markets and cheaply buy, sell, and diversify their portfolio, and exit at any time. The increased ownership dispersion and market liquidity meant weaker shareholder control, the consequence being a reactivation of the market for corporate control.[101] Corporations began to merge in the form of conglomerates with multi–divisional diversification. However, conglomerates were accused of being financially ineffective while the US struggled against stagflation and global competitive pressures from East Asia.[102] Once again, several legal measures were taken against the conglomerates. One of these legal measures was the Williams Act that aimed at limiting hostile takeover attempts via tender offers, which was the widely used method of acquisition to form conglomerates in that period.[103]

Two of these acquisitions came to the SEC's attention in *Genesco* and *Georgia-Pacific* proceedings, in which each corporation engaged in share repurchase programs on the open market to inflate the market price of their shares in order to facilitate acquisitions each company was trying to make.[104] Similarly, the SEC issued a stop order upon its finding that another corporation had

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[100] These acts include Investment Companies Act of 1940, which require investment companies to inform investors via disclosure, and Investment Advisers Act of 1940, which require investment advisers to register with the SEC to protect investors. See Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (Aug. 22, 1940); Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (Aug. 22, 1940).

[101] John Armour & Brian R. Cheffins, *The Origins of the Market for Corporate Control*, 5 U. ILL. L. REV. 1835 (2014) (arguing that the modern form of the market for corporate control emerged when cash tender offers came to dominate the market after the World War II, and this dominance can be explained primarily by changes in the pattern of share ownership and reduced opportunities bidders had for managing the stock price of intended targets).

[102] Lazonick, *supra* note 42, at 419 (stating that conglomerates lacked specialization and further arguing that the lack of specialization refrained US corporations from competing against the global pressures especially from innovative East Asian corporations).

[103] GAUGHAN, *supra* note 96, at 50.

[104] Genesco, Inc., [1964–1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,354 (May 10, 1966) (The corporation had repurchased its own shares to inflate their market price for the purpose of making exchange ratios appear more favorable to shareholders of target corporations during the acquisition of these corporations through exchange tender offer); SEC v. Georgia-Pacific Corp., [1964–1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,680 (S.D.N.Y. 1966)

engaged in extensive and undisclosed share repurchase programs on the open market through several of its subsidiaries for the purpose of supporting the market price of their own shares to maintain the value of shares pledged by insiders as collateral for bank loans.[105] Shortly after these abuses, the SEC initially proposed Rule 10b-10 regarding OMRs in connection with proposed legislation that became the Williams Act Amendments of 1968.[106] The proposed Rule 10b-10 prescribed substantive restrictions for corporations in connection with the purchase of their own shares. The proposed rule was, however, found to be too restrictive to be enacted.

In line with certain restrictions established in previous proceedings, a rule similar to the previously proposed Rule 10b-10 was proposed a few times under the proposed Rule 13e-2 in 1970, 1973, and 1980.[107] All of the versions of the proposed Rule 13e-2 included a prescriptive rule that would make market repurchases unlawful unless transactions were conducted according to certain trading conditions as well as a provision that authorizes the SEC to approve repurchases on a case-by-case basis. Subsequent versions of the rule in 1973 and 1980 additionally included an initial disclosure requirement for corporations to publicly disclose details of transactions including insiders' intent

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(The corporation had repurchased its own shares to inflate their market price for the purpose of reducing the number of shares required to be issued pursuant to contingent obligations owed to former shareholders of the target corporation following the acquisition of the corporation).

[105] Atlantic Research Corp., Exchange Act Release No. 4657, [1961–1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,949 (Dec. 6, 1963).

[106] The Williams Act Amendments of 1968, Pub. L. No. 90-439, 82 Stat. 454 (July 29, 1968), *reprinted in Hearings on S. 510 before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. 214–216 (1967).

[107] Exchange Act Release No. 8930, 35 Fed. Reg. 11,410 (proposed July 16, 1970); Repurchase of Securities and Prohibitions Against Certain Trading, Exchange Act Release No. 10,539, 38 Fed. Reg. 34,341 (proposed Dec. 13, 1973); Purchases of Certain Equity Securities by the Issuer and Others, Securities Act Release No. 6248, Exchange Act Release No. 17,222, Investment Company Act Release No. 11,403, 45 Fed. Reg. 70,890 (proposed Oct. 27, 1980). For an extensive summary of the regulatory landscape and regulatory proposals in the beginning of the 1970s and the recommendation for the SEC to adopt the disclosure regime as the main organizing principle with respect to stock repurchases that forms a basis for the enactment of the Rule 10b-18, see Robert J. Malley, *Corporate Repurchases of Stock and the SEC Rules: An Overview*, 29 BUS. LAW. 117 (1973).

for trading around repurchases. However, none of these versions of the proposed Rule 13e-2 were enacted since they were also found to be too restrictive like the proposed Rule 10b-10.

4. The Rule 10b-18

The rejection of the proposed rules could be regarded as a sign of increasing suspicion towards the pro–regulative political stance taken in the wake of the Great Depression. Yet, the purported failure of the US economic and corporate system against global competitive pressures in the 1960s caused neoliberal policies to gain wider acceptance. The theory of corporations has also been reinterpreted from a liberal economic perspective. The dominant corporate theory until the 1970s used to rely on the doctrine of separate legal personality and consider managers as sole agents to act in the best interests of corporations and all corporate stakeholders.[108] These managerial corporations were criticized and an economic theory of corporations, which redeveloped the aggregate theory that puts shareholders in the center of corporations, was introduced by the 1970s.[109]

In line with the advent of neoliberalism and shareholder capitalism, capital markets were further liberalized and activated, and institutional shareholders arose and dominated markets in the 1980s.[110] Institutional shareholders have been more active than retail shareholders. Yet,

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[108] E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Are Trustees?*, 45 HARV. L. REV. 1145 (1932) (arguing that managers are trustees for corporations).

[109] For the aggregate theory, see Adolf A. Berle, Jr., *For Whom Managers Are Trustees?: A Note*, 45 HARV. L. REV. 1365 (1932) (arguing that managers are trustees for shareholders not for corporations). For a comprehensive analysis of the economic theory of corporations that was built upon the aggregate theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989).

[110] Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN., Jan. 2007, at 55 (stating that the involvement of large institutional shareholders increased dramatically with the advent of public pension fund activism during the mid–1980s).

institutional shareholders are able to better monitor managers and compel them to follow strategies that would distribute cash to shareholders and increase the value of their investments. All of these strategies could be achieved by OMRs since they increase share price and EPS while resulting in the distribution of cash to shareholders.

Undoubtedly, the main component of globalization-induced neoliberalism includes deregulation. As part of the deregulation process, the SEC—after withdrawing all the previous proposed rules for finding them too restrictive—(de)regulated OMRs so as to permit corporations to repurchase their shares on the open market by adopting the Rule 10b-18 in 1982.[111] Indeed, the predecessors of the Rule 10b-18 were prescriptive in nature with mandatory disclosure requirements, substantive purchasing limitations, and general anti–fraud liability. Rather, the Rule 10b-18 prescribes a non-exclusive safe harbor that protects issuers from potential liability under the Rule 10b-5 as long as they comply with conditions on the time, manner, volume, and price of OMRs.[112] Recalling that the initial objective of previous proposed rules was to limit OMR activity due to the potential of exploitation that would result in market abuse, the adoption of the Rule 10b-18 represents a clear policy change in that the safe harbor rule, unlike its predecessors, is not prescriptive.[113]

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[111] Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Securities Act Release No. 6434, Exchange Act Release No. 19,244, Investment Company Act Release No. 12,823, 47 Fed. Reg. 53,333 (adopted Nov. 26, 1982) [hereinafter referred to as 1982 Adopting Release].

[112] *See* Rule 10b-18(b)–(d).

[113] William Lazonick, *From Innovation to Financialization: How Shareholder Value Ideology is Destroying the US Economy, in* THE HANDBOOK OF THE POLITICAL ECONOMY OF FINANCIAL CRISES 491, 506 (Martin Wolfson & Gerald Epstein eds., 2013) (quoting the rulemaking process, in which John Shad, the then-chairman of the SEC, advocated for the rule change and argued that large-scale open market purchases would fuel an increase in stock prices that would be beneficial to shareholders, whereas one of the SEC commissioners, John Evans, argued that some manipulation would go unprosecuted due to the rule, however he later agreed to make the Commission's vote for the rule change unanimous).

5. Amendments in 2003

In the 1980s, the market for corporate control, which has been a market-oriented mechanism of control that threatens to replace inefficient management, became active with another takeover wave.[114] This wave mainly included acquisition methods such as hostile takeovers and leveraged buyouts that are largely debt-financed. Debt-finance appears as another market-oriented mechanism of control that constrains management by increasing debt burden and reducing discretionary cash surplus.[115] However, high level of debt also increases financial risks. These inherent risks raised concerns over shareholder primacy but efforts to alter shareholder-centered approach largely remained inconclusive.[116] Moreover, corporate scandals were unveiled at the turn of the twenty-first century. These scandals proved the inefficiency of shareholder monitoring as well as internal monitoring by boards, external monitoring by securities analysts, executive compensation, and auditing and accounting mechanisms.[117] In response to these corporate governance scandals, the Congress passed the Sarbanes-Oxley Act of 2002 to further enforce corporate accountability to shareholders.[118] For this purpose, the Act requires several reforms, one of which has been enhanced financial disclosures.[119]

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[114] *See generally* Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 SCIENCE 745 (1990).
[115] *Id.* at 748.
[116] For the efforts to replace shareholder-centered approach with a more inclusive approach, see Freeman, R. Edward & William M. Evans, *Corporate Governance: A Stakeholder Interpretation*, 19 J. BEHAV. ECON. 337 (1990); Charles W. L. Hill & Thomas M. Jones, *Stakeholder Agency Theory,* 29 J. MGMT. STUD. 131 (1992). *See* also Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASHINGTON U. L.Q. 403 (2001).
[117] Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125 (2003).
[118] *Id.*
[119] *Id.*

In this context, the absence of a mandatory disclosure regime on OMRs also came into question. Such absence made it easier for corporations to repurchase fewer shares than their announced targets,[120] or to go unnoticed while failing to comply with the conditions laid out in the safe harbor rule.[121] In response, the SEC adopted amendments to the Rule 10b-18 in 2003 and introduced mandatory disclosure requirements.[122] Accordingly, regardless of whether the repurchases are effected in accordance with the safe harbor rule, reporting issuers must report their repurchasing activity as required by Item 703 of Regulations S-K and S-B (17 C.F.R. § 229.703 and 228.703), Item 15(e) of Form 20-F (17 C.F.R. § 249.220f) (regarding foreign private issuers), and Item 8 of Form N-CSR (17 C.F.R. § 249.331; 17 C.F.R. § 274.128) under the Exchange Act and the Investment Company Act of 1940 (regarding closed-end management investment companies).[123]

The mandatory disclosure requirement obliges corporations to disclose information on their monthly repurchase activity including OMRs on their quarterly public filings and annual statements after-the-fact.[124] In this context, corporations are required to disclose the total number of shares repurchased during the specified period, the average price paid for repurchased shares,

[120] For the statistical evidence on the low completion rates of announced repurchases until 2003, Clifford P. Stephens & Michael S. Weisbach, *Actual Share Reacquisitions in Open Market Repurchase Programs*, 53 J. FIN. 313 (1998) (stating that within 3 years of announcing a repurchase, 43 percent of firms repurchased fewer shares than their announced targets, 10 percent of firms bought less than 5 percent of the number of shares announced, and a significant number of firms did not repurchase any shares at all).

[121] For the statistical evidence on the low level of compliance of corporations to the safe harbor rule, see Douglas O. Cook et al., *An Analysis of SEC Guidelines for Executing Open Market Repurchases*, 76 J. BUS. 289 (2003) (showing that only two of fifty-four firms that repurchased their shares from March 1993 to March 1994 complied with the safe harbor rule for all reported repurchasing in the US).

[122] For the explanation of the SEC on the reason for introducing mandatory disclosure requirements, see 2003 Amending Release, *supra* note 44, at 68 Fed. Reg. 64,961–63.

[123] *Id.*

[124] *Id.*

the total number of shares that were purchased in the specified period as part of a publicly announced plan, and the maximum number of shares, or approximate dollar value, that may yet be repurchased under any share repurchase plan. Moreover, in addition to announcements that are required by securities exchanges for corporations to announce their OMR plans before-the-fact,[125] corporations are also required to disclose information regarding their OMR plans; namely, the date each plan was announced, the dollar (or share or unit) amount approved, the expiration date (if any) of each plan, each plan that has expired during the period covered by the disclosure, and each plan the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases. While the introduction of mandatory disclosure requirements enhanced the transparency and thereby the completion rate of OMR programs,[126] problems inherent in the safe harbor rule remain.[127]

C. Purported Benefits of OMRs in the US

The number of OMRs has dramatically increased following the deregulation of OMRs in 1982 (see Appendix 1). The deregulation might have caused the increase by enabling corporations to more easily execute OMRs.[128] However, the primary reason for the increase appears to be the same reason that precipitated deregulation; namely, the advent of neoliberalism that instigated financialization and shareholder capitalism. Indeed, share repurchases led by OMRs have a

[125] *See, e.g.*, NASDAQ Rule IM-5250-1.
[126] Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Repurchases*, 6 BERKELEY BUS. L.J. 96 (2009) (comparing the completion rates of announced repurchases before and after the amendments in 2003 and finding that corporations are more likely to complete their announced repurchases and do so within a shorter time period following the repurchase announcement since the disclosure requirement became mandatory with the amendments in 2003).
[127] For problems inherent in the safe harbor rule, see Chapter II.D.1.1.1.
[128] Grullon & Michealy, *supra* note 3, at 1683.

number of functions for shareholder-oriented corporations operating in increasingly financialized liberal markets. Yet, these corporations seek to maximize shareholder value while mitigating agency costs.[129] Agency costs arise from the conflicting interests of parties to the agency relationship, namely shareholders (principals) and managers (agents), that derives from the feature of Berle-Means corporations, i.e. the separation of ownership and control.[130] In these corporations, managers tend to be risk-averse, prefer low-risk-low-return investments, and may therefore retain and reinvest cash to make new investments and expand the business.[131] Shareholders, on the other hand, tend to seek high-risk-high-return investments and, in the absence of such investments, prefer corporations to distribute cash to themselves,[132] and thereby actively monitor managers to advance that preference.

However, another feature of Berle-Means corporations, namely ownership dispersion, inhibits dispersed shareholders from actively monitoring managers. This is because costs associated with monitoring could be prohibitively high for dispersed shareholders due to their rational apathy arising from ownership dispersion.[133] On the other hand, the rise of institutional shareholders hold larger stakes, suffer less from rational apathy, and more actively monitor managers compared to retail investors. Thus, institutional shareholders are able to compel managers to pursue

[129] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure,* 3 J. FIN. ECON. 305, 308 (1976).
[130] *Id.*
[131] BERLE & MEANS, *supra* note 82, at 123–24 (claiming that if those in control of a corporation reinvests its profits in an effort to enlarge their own power, their interests might run directly counter to those of the owners of the corporation).
[132] *Id.* at 121–22 (claiming that it is to the interests of owners of a corporation when the corporation maximizes its profit within a reasonable degree of risk and distributes the profit as much as possible and nothing should happen to impair their rights to receive their equitable share of the profit).
[133] *Id.* at 81 (claiming that the normal apathy inherent in shareholders with smaller stakes would cause them to not effectively exercise their voting rights either by failing to return proxy or signing on the dotted line and returning his proxy to the office of the corporation).

shareholder-value enhancing policies led by payouts to shareholders.[134] Shareholder payouts, particularly dividends, would mitigate agency costs by enabling managers to disburse corporate cash to shareholders.

Share repurchases are also regarded as a payout method alternative to dividends. This is because share repurchases enable corporations to distribute cash to shareholders by purchasing their own shares from shareholders. Interestingly, the number of share repurchases has increased faster than dividends, and as a result, the percentage of share repurchases to total payouts surpassed the percentage of dividends to total payouts towards the end of the 1990s.[135] Hence, the dominance of share repurchases and particularly OMRs over dividends has been attributed to various advantages of OMRs over dividends. These advantages include the reduced tax liability, the cost-effective signalling of undervaluation, the increased flexibility and market liquidity, the supplying of shares for dividend reinvestment plans, and the offsetting of dilution.[136]

However, there might be other reasons for the increase in the number of repurchases led by OMRs. OMRs, unlike other payout methods, have purportedly beneficial functions other than the efficient distribution of cash to shareholders. One of these functions has been that OMRs bolster executive compensation.[137] The major components of executive compensation have been stock options and

[134] LYNN A. STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 93–94 (2012).
[135] Grullon & Michaely, *supra* note 3, at 1649, 1655 (reporting that share repurchases as a percentage of total dividends increased from 13.1 percent in 1980 to 113.1 percent in 2000).
[136] *See infra* Section 1.
[137] *See infra* Section 2.

stock awards that are tied to share prices and financial metrics of corporations.[138] The objective of stock-based pay is to align the interests of managers with those of shareholders, and mitigate agency costs by incentivizing managers to pursue policies that increase share prices and improve financial metrics, which ultimately enhance shareholder value as well as managers' financial interests.[139] In this context, OMRs have multiple functions in bolstering executive compensation. Thus, the function of OMRs in bolstering executive compensation seems to be another reason for the increase in the number of OMRs.

The advent of neoliberalism has also caused an increase in financialization. OMRs, as financial tools, provide managers leverage on financing corporations that might benefit shareholders by increasing shareholder value.[140] Increasing financialization also activates the market for corporate control. In an active market for corporate control, incumbent managers would want to use OMRs to deter potential hostile takeover attempts in an effort to entrench their managerial positions, while benefiting shareholders in certain circumstances.[141] Corporations may also execute OMRs in order to supply shares for ESOPs.[142] Agency theory that focusses on the relationship between managers and shareholders often omits employees from the corporate governance equation. Consequently, employees have weak representation rights. Instead, they are offered financial participation schemes led by ESOPs that also link employee compensation to share price performance. This linkage may incentivize employees to not resist shareholder-value increasing policies.

[138] Lazonick, *supra* note 40, at 48 (reporting that the 500 highest-paid executives named in proxy statements of US public companies in 2012 received, on average, $30.3 million each; 42% of their compensation came from stock options and 41% from stock awards).
[139] Jensen & Meckling, *supra* note 129.
[140] *See infra* Section 3.
[141] *See infra* Section 4.
[142] *See infra* Section 5.

Consequently, the functions of OMRs in corporate finance, the defensive use of OMRs as well as the function of OMRs in supplying shares for ESOPs appear as other potential reasons for the increase in the number of OMRs.

These functions of OMRs, which were mainly raised by the previous literature, deserve further examination. Hence, this part is divided into five sections in order to critically examine these functions and to find out whether they are actually beneficial and, if so, to what extent they are beneficial for shareholders. To this end, the first section reviews the purported benefits of OMRs as a method for distributing cash to shareholders in comparison with alternative payout methods led by dividends. The second section examines multiple functions of OMRs that bolster the executive compensation, which would benefit directly managers and indirectly shareholders by mitigating agency costs. The third section evaluates instances in which OMRs provide managers leverage in corporate finance for the purpose of forming an optimal financial structure to increase shareholder value and benefit shareholders. The fourth section summarizes the defensive use of OMRs in the market for corporate control and explains how OMRs executed for defensive purposes help managers entrench their positions while benefiting shareholders only in certain circumstances. The last section reviews the function of OMRs in supplying shares for ESOPs that might benefit shareholders by aligning interests of employees with those of shareholders.

1. Distributing Excess Cash to Shareholders Efficiently

Agency costs arise due to potential conflicts of interests between principals and their agents, namely shareholders and managers in the case of corporations. Jensen and Meckling theorized that this conflict could be mitigated if shareholders receive "free cash flow" of the company as return on their investments. The default method for shareholders to receive return on their investments is to sell their shares, which is colloquially known as "homemade dividends".[143] Nevertheless, managers had traditionally made decisions to distribute excess cash to shareholders in the form of regular dividends. Thus, earlier studies focussed on the potential effects of dividend decisions.

The Miller and Modigliani dividend irrelevance theory was the first to initially address the effect of dividend policies of corporations on the share price or the capital structure of the company. The irrelevance theory argues that a corporation's dividend policy has no or little impact on the share price by relying on assumptions, under which capital markets are perfect. These assumptions are that taxes are neutral; transfer taxes, brokerage fees and other transaction costs do not distort financial markets; and there is no information asymmetry so that investors, who are assumed to be rational, are perfectly certain about the future prospects of the corporation.[144]

However, these assumptions do not conform with the real world, and corporations have paid out more cash after the advent of agency theory and shareholder value theory.[145] In this context, share repurchases, particularly OMRs as the most common form of repurchases due to their bargain feature, have become an alternative payout method in the 1980s.[146] The dramatic increase in the

[143] Hersh M. Shefrin & Meir Statman, *Explaining Investor Preference for Cash Dividends*, 13 J. FIN. ECON. 253, 253 and 277 (1984).
[144] Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961).
[145] For the increase in the number of dividends as well as other payout methods in the US, see Appendix 1 and sources cited *supra* note 3. For agency-cost explanations to dividends, see Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650 (1984).
[146] Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV., May 1986, at 323, 324 (arguing that managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out cash that would otherwise be invested in low-return projects or wasted). OMRs resemble

number of OMRs since the 1980s caused share repurchases to surpass dividends for the first time in 1997 (see Appendix 1). Since then, share repurchases led by OMRs have been more frequently used to distribute excess cash to shareholders, except for during temporary market downturns.[147] The dominance of share repurchases caused most of the payout policy debate to shift towards supporting share repurchases as contrasted to regular dividends.

Hence, this section reviews the potential advantages of share repurchases, and particularly OMRs, over dividends mainly from the shareholder perspective. These potential advantages that are discussed in the literature include but are not limited to reduced transaction costs, and in particular reduced tax liability, the cost-effective signalling of undervaluation, increased flexibility and market liquidity, supplying shares for dividend reinvestment plans, and offsetting dilution. Thus, this section reviews these factors that might affect a corporation's choice of payout method between OMRs and dividends in six subsections. The objective of this review is to determine the nature of the relationship between OMRs and dividends and whether these factors are able to fully explain the dominance of OMRs over dividends.

1.1 Providing Tax Advantage

regular dividends in that it requires managerial action for corporations to distribute cash to shareholders. OMRs also resemble to homemade dividends as cash is distributed only to shareholders who wish to sell their shares (to the corporation) and have cash in return.

[147] Corporations attach importance to the stability of dividends so that they tend to give up repurchases for dividends when their free cash flows decrease under adverse market conditions. For further information on this particular factor that affects the choice of payout methods of corporations, see *infra* Section 1.3.

The use of share repurchases instead of dividends is widely thought to be due to the historical tax advantage of share repurchases over dividends for shareholders.[148] This is because proceeds of shareholders selling their shares within a repurchase program are taxed as capital gains, whereas dividends are taxed as ordinary income. Capital gains were taxed at lower rates than ordinary income until 2003. In 2003, the dividend tax cut started treating dividend income differently than ordinary income, resulting in the alignment of the highest marginal rate on both qualifying dividends and long-term capital gains at 15%.[149] According to the current tax scheme in the US, qualified dividends are taxed at the long-term capital gains rate, while the tax rate applicable to non–qualified dividends is equal to the tax rate on short-term capital gains.

Despite the tax rate parity, share repurchases are still slightly more tax-efficient than dividends. Yet, shareholders, who sell their shares, are taxed only on gains above their basis in the stock, whereas dividends are fully taxed.[150] In addition to this slight but ongoing tax advantage of share repurchases over dividends, share repurchases may also be more tax-efficient than dividends with regard to aggregate tax burden on shareholders.[151] The claim relies on the fact that all taxable shareholders are taxed on their pro rata share of the dividend, whereas only shareholders, who choose to sell their shares, are taxed in cases of share repurchases.[152] Hence, in order for the

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[148] William W. Bratton, *The New Dividend Puzzle*, 93 GEO. L.J. 845, 854–61 (2005) (referring to much discussed dividend puzzle termed by Black (1976) and arguing that repurchases were historically advantageous over dividends until the tax parity between dividends and repurchases, which has created a new, real-world dividend puzzle posed in the boardrooms of firms with free cash flow).

[149] *Id.* at 845. For the impact of dividend tax cuts on dividends and repurchases, see Raj Chetty & Emmanuel Saez, *Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut*, 120 Q.J. ECON. 791, 793–94 (2005) (documenting a 20% increase in dividend payments following the tax cut by the Jobs and Growth Tax Relief Reconciliation Act of 2003 but suggesting that the dividend increase did not crowd out repurchases).

[150] Fried, *supra* note 43, at 1337.

[151] *Id.*

[152] *Id.*

aggregate tax burden to be reduced, higher tax bracket shareholders must avoid selling their shares, while tax-exempt or lower tax bracket shareholders must sell their shares within a share repurchase program.[153]

Many institutional shareholders are tax-exempt and many retail shareholders hold shares in tax-favored accounts.[154] However, executives believe that retail shareholders, who would typically be subject to higher tax brackets than institutional shareholders, have a strong preference for dividends, whereas institutional shareholders have no tax-driven preference between dividends and repurchases.[155] The conflicting results of shareholder preferences indicate that the tax advantage of share repurchases over dividends has not been of primary importance for corporations in determining their payout policies. Indeed, the majority of executives would not consider tax implications of their payout policies on shareholders.[156]

This observation is consistent with the resilience of dividends and their coexistence with share repurchases. In other words, corporations continue to pay dividends for some other reasons regardless of the tax advantage of share repurchases over dividends. The negative correlation between the tax advantage of share repurchases over dividends and the number of repurchases also supports this observation. Accordingly, the number of repurchases has increased throughout the decline of the tax advantage of share repurchases over dividends and even after the tax parity.

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[153] *Id.*

[154] *Id.*

[155] Alon Brav et al., *Payout Policy in the 21st Century*, 77 J. FIN. ECON. 483, 485, 509–10 (2005). For the psychological explanation on investor preference for dividends despite their tax disadvantage, see Shefrin & Statman, *supra* note 143 (arguing that investors tend to favor cash dividends due to the theory of self-control by Thaler and Shefrin (1981) and the version of prospect theory set out by Kahneman and Tversky (1979)).

[156] Brav et al., *supra* note 155, at 485–86 (two-thirds of the executives say that the dividend tax reduction in 2003 would definitely not or probably not affect their dividend decisions).

Consequently, the tax advantage of share repurchases over dividends fails to explain the increase in the number of repurchases and of OMRs.

1.2 Cost-Effective Signaling of Information

The irrelevance theory assumes that information is perfect.[157] This assumption underlies the main assumptions of modern finance, namely the efficient capital market hypothesis and capital asset pricing model. According to these assumptions, market prices are informationally efficient since rational investors instantly respond to new information and value shares pursuant to their expected return and non–diversifiable risk.[158] In this context, it is impossible to beat the market and purchase undervalued shares (or sell overvalued shares) because shares would always be traded at fair value owing to information available to all investors that invest rationally.[159] However, investors do not always invest rationally and information asymmetries exist among investors, particularly between insiders and outsiders of corporations. Consequently, the market value of shares based on calculations of irrational outsiders with limited information may be lower than the intrinsic value of shares. Particularly in these cases, insiders may adopt strategies that might convey positive information they have about their corporations to outsiders. These strategies include corporate disclosures on OMRs.[160]

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[157] *See supra* note 144 and accompanying text.
[158] Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 475–76 (1997).
[159] *Id.*
[160] Brav et al., *supra* note 155, at 511 (reporting that eighty percent of executives believe that dividend decisions convey information to investors, whereas 85.4% of executives feel that repurchase decisions convey information).

Apart from the information signalling function of disclosure of actual OMR data in earnings announcements,[161] announcements of OMR plans might initially make corporate outsiders think that management has excess cash to spend on OMRs and/or tends to repurchase undervalued shares. Hence, outsiders tend to react to OMR announcements positively, resulting in an increased demand for corporate shares that would ultimately increase share prices, at least, in the short-term.[162] In other words, the possibility of corporations to repurchase their own shares on the open market at any time would enable corporations to support and stabilize share prices.[163] Moreover, OMR announcements are costless signals since OMR announcements are not firm commitments. That is to say, corporations announcing their OMR plans are not obliged to repurchase even a single share. Rather, announcements of OMR plans give managers only the option to buy shares on behalf of the corporation itself.[164]

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[161] Azi Ben-Rephael et al., *Do Firms Buy Their Stock at Bargain Prices? Evidence from Actual Stock Repurchase,* 18 REV. FIN. 1299 (2014) (arguing that OMR activity is followed by a positive and significant abnormal return after disclosure of actual OMR data in earnings announcements, and this positive response is followed by a 1-month drift).

[162] Utpal Bhattacharya & Stacey Jacobsen, *The Share Repurchase Announcement Puzzle: Theory and Evidence,* 20 REV. FIN. 725 (2016) (finding that OMR announcements would attract speculators and inflate share prices especially when shares are undervalued by a large margin). However, OMRs may adversely convey negative information depending on investor expectations in that some shareholders may regard an increase in payout, particularly OMRs given their flexibility, as an indicator of the corporation either passing up or having no investment opportunities. *See* Brav et al., *supra* note 155, at 490 and 497 (reporting that less than half of the executives sees the availability of good investment opportunities as an important factor affecting dividend decisions, whereas 80% of executives report that the availability of good investment projects is an important factor affecting repurchase decisions, but most executives do not seem concerned about the potential of conveying negative information in that less than one-fifth of executives think that the possibility that paying dividends might indicate to investors that their company is running low on profitable investments is an important factor affecting payout policy, whereas a statistically larger 32.3% of executives believe that repurchasing decisions might indicate a lack of investment opportunities).

[163] Indeed, the SEC had temporarily relaxed certain rules applicable to OMRs after the market crashes of October 1987 and September 2001 in an effort to encourage corporations to announce and/or execute OMRs to support and stabilise their share price.

[164] David L. Ikenberry & Theo Vermaelen, *The Option to Repurchase Stock,* 25 FIN. MGMT., Winter 1996, at 9–10 (stating that OMR announcements are not firm commitments, framing that the lack of commitment distinguishes OMRs from other repurchasing methods and provides managers the flexibility to buy back shares when they view their stock as undervalued to the benefit of long-term shareholders or otherwise forego repurchasing shares, and valuing this inherent flexibility as an exchange option in which the market price of the stock is exchanged for the true value of the stock whereas OMRs would not appear to be the optimal repurchasing method to signal that shares are undervalued, particularly when more effective mechanisms such as fixed price or Dutch-auction tender offers exist).

However, the lack of commitment of OMR announcements curbs their signalling content and makes them less credible signals than those of other repurchasing methods, such as fixed price or Dutch-auction tender offers.[165] Moreover, if shares to be repurchased are undervalued by a small margin and that would cause OMR announcements to fail to attract investors, corporations might have to execute OMRs as a value-correcting signal that would come at a cost.[166] Consequently, auditors' reports and corporate earnings forecasts appear to be the primary corporate instruments that corporations can also use to signal information at even lower prices than OMRs.

On the other hand, announcements of dividend increases also have a signalling effect and corporations may choose to signal via announcements of dividends or OMRs or a combination of both.[167] However, dividend announcements increase share prices less than OMR announcements.[168] The relatively low signaling power of dividends might partly be due to the tendency of corporations to increase dividends only for smaller distributions.[169] This tendency

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[165] *Id.* at 22 (arguing that the inherent flexibility which gives rise to the exchange option makes OMRs less appealing as credible signals, particularly when other more credible repurchase mechanisms exist). *See also* Theo Vermaelen, *Common Stock Repurchases and Market Signalling: An Empirical Study*, 9 J. FIN. ECON. 139, 180 (1981) (finding that results in support of the information hypothesis for open market repurchases are less conclusive than those for repurchase tender offers but are consistent with an information hypothesis if repurchases can be perceived as an indirect form of insider buying via executive stock compensation plans); Robert Comment & Gregg A. Jarrell, *The Relative Signalling Power of Dutch Auction and Fixed Price Self Tender Offers and Open Market Share Repurchases*, 46 J. FIN. 1243 (1991) (comparing three forms of common stock repurchases and finding that OMRs are associated with the lowest returns). Another contributing factor for the low signalling power of OMR announcements might be that OMRs are typically smaller than other repurchasing methods. *See* Brennan & Thakor, *supra* note 41 (claiming that shareholders prefer corporations to distribute larger amounts via tender offers instead of OMRs).

[166] Bhattacharya & Jacobsen, *supra* note 162 (developing a theoretical model that predicts that OMR announcements fail to attract speculators and increase share prices when shares are undervalued by a small margin, and in these cases, corporations use costly share repurchases as a value-correcting signal).

[167] Aharon R. Ofer & Anjan V. Thakor, *A Theory of Stock Price Responses to Alternative Corporate Cash Disbursement Methods: Stock Repurchases and Dividends*, 42 J. FIN. 365 (1987).

[168] *Id.*

[169] Brennan & Thakor, *supra* note 41 (finding that a majority of shareholders may support a dividend payment for small distributions, OMRs for larger distributions, repurchase tender offers for the largest distributions); Bratton,

might be because dividends are default payment methods and firm commitments to pay out (recurring) cash to shareholders. Hence, corporations hesitate to increase dividends because that might give shareholders the impression that the corporation makes a commitment to pay higher dividends regularly.[170] If corporations substantially increase dividends, they might have to cut dividends in the future, with such cuts being regarded predominantly as negative.[171] Thus, dividend-paying corporations hesitate to radically change (reduce) the amount of dividends. This hesitation partly explains why dividend-paying corporations continue to pay dividends and complements them with OMRs to smooth dividends.[172] Consequently, the signaling hypothesis suggests that share repurchases and dividends complement each other and co–exist in a corporation's payout policy, rather than the former substituting for the latter. Therefore, the information signaling hypothesis is estimated to be an insignificant contributor to the increase in the number of OMRs.

1.3 Providing Flexibility

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supra note 148, at 865 (arguing that the relatively low average abnormal return following dividend announcements can be partly accounted for by reference to the size of the incremental cash distribution).

[170] Wayne Guay & Jarrad Harford, *The Cash-Flow Permanence and Information Content of Dividends Increases versus Repurchases*, 57 J. FIN. ECON. 385 (2000) (finding that corporations choose dividend increases to distribute relatively permanent operating cash-flows and that the market reaction to dividend increases is more positive than the reaction to repurchases once controlled for payout size and the market's expectation about the permanence of the cash-flows).

[171] Bratton, *supra* note 148, at 863 (citing previous studies that find on average that a dividend increase yields a 1% announcement-period increase in the stock price, whereas a dividend cut produces a 6% price drop on the three days surrounding the announcement of a dividend cut).

[172] Brav et al., *supra* 155, at 499–501 (reporting that almost 90% of executives stated that cutting dividends has negative consequences and 84.1% of executives argued that maintaining consistency with the historic dividend policy is an important factor, while only 22.5% of executives claimed that reducing share repurchases has negative consequences and 22.1% of executives believe that maintaining consistency with historic repurchase policy is important).

The lack of commitment of OMR announcements undermines their credibility and thereby their signalling content, but makes OMRs a more flexible means of distributing cash to shareholders.[173] This flexibility appears to be a potential reason for corporations to announce (and execute) OMRs. Yet, such flexibility enables managers to decide whether and when to execute OMRs and how much cash to allocate for repurchasing shares depending on the level of share price as well as the market- and firm-specific factors.[174] More specifically, the flexibility of OMRs enables corporations to pay out non–recurring excess cash flows without obliging them to continue to pay out at higher levels in the long-term, unlike with regular dividends, given market expectations.[175]

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[173] *See supra* note 164.

[174] Murali Jagannathan et al., *Financial Flexibility and the Choice between Dividends and Stock Repurchases,* 57 J. FIN. ECON. 355 (2000) (finding that repurchases are pro–cyclical and are used by firms with higher temporary non–operating cash flows; repurchasing firms have much more volatile cash flows and distributions and repurchase shares following poor stock market performance; and arguing that these results are consistent with the view that the flexibility inherent in repurchase programs is one reason why corporations are sometimes used instead of dividends); Brav et al., *supra* note 155, at 485 and 520 (reporting that the flexibility of repurchases allows managers to alter payout in response to the availability of good investment opportunities, to repurchase undervalued shares, to accommodate time-varying attempts to affect EPS or share valuation, to offset dilution, or simply to distribute cash to shareholders at the appropriate time, and concluding that executives state that the flexibility of repurchases is one of the main reasons that repurchases have increased). For a recent analysis on the flexibility of share repurchases during financial crisis periods, see Subramanian Rama Iyer & Ramesh P. Rao, *Share Repurchases and the Flexibility Hypothesis*, 40 J. FIN. RES. 287 (2017) (documenting that the proportion of repurchasing firms that reduced repurchase payouts is greater than the proportion of dividend payers that reduced their dividends during the financial crisis period, and concluding that share repurchases are more flexible than dividends).

[175] Jagannathan et al., *supra* note 174 (finding that dividends are paid by firms with higher permanent operating cash flows, while repurchases are used by firms with higher temporary non–operating cash flows); Guay & Harford, *supra* note 170 (finding that firms choose repurchases to distribute more transient cash-flow shocks); Brav et al., *supra* note 155, at 500 (finding substantial differences between the forms of payout in relation to a temporary increase in earnings, with about one-third of firms that repurchase say that a temporary increase in earnings is an important factor while only 8.4% of dividend payers say that a temporary increase in earnings is important to dividend decisions, and excess cash on the balance sheet is more important to repurchase decisions than it is to dividend decisions, and citing that executives state that the flexibility of repurchases compared to dividends is one of the main reasons that repurchases have increased). *See also* David J. Denis & Igor Osobov, *Why Do Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy,* 89 J. FIN. ECON. 62 (2008) (studying payout policies of firms in the US, Canada, UK, Germany, France, and Japan, and finding that the propensity to pay dividends is higher among larger, more profitable firms, and those for which retained earnings comprise a large fraction of total equity and thereby aggregate dividends have not declined and are concentrated among the largest, most profitable firms in each country, whereas newly listed firms fail to initiate dividends that accounts for the reductions in the propensity to pay dividends in most of the sample countries over the 1994–2002 period, and concluding that this finding support agency cost-based lifecycle theory).

It should be noted that one of the reasons for the flexibility of OMRs being regarded as an advantage is based on the assumption that managers can time the market and execute OMRs when shares are undervalued. However, shares may not be undervalued when the corporation has non-recurring excess cash, which might cause managers to mistime the market, and in this case, the flexibility of OMR announcements would come at a price.[176]

On the other hand, non–recurring excess cash flows could also be flexibly distributed to shareholders by way of special dividends. Stating that dividends are special may prevent shareholders from expecting that they will be paid on a regular basis.[177] Special dividends were largely used to distribute cash to shareholders until the 1970s, with OMRs rising to prominence in the 1980s.[178] However, larger special dividends continue to exist due to their size that differentiates them from regular dividends.[179] Another reason for the survival of large special dividends might

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[176] Ikenberry & Vermaelen, *supra* note 164, at 22 (arguing that if managers fail to correctly detect deviations between market prices and book prices, they may buy overvalued shares that would be detrimental to long-term shareholders). For another claim on the potential cost of financial flexibility, see Alice A. Bonaimé et al., *The Cost of Financial Flexibility: Evidence from Share Repurchases*, 38 J. CORP. FIN. 345 (2015) (documenting a significant cost associated with flexibility of share repurchases as actual repurchase investments underperform a repurchase strategy with little or no flexibility by approximately two percentage points per year on average, and finding that the cost of financial flexibility is positively correlated with earnings management, managerial entrenchment, and less institutional monitoring). For further discussion on the managerial timing ability and their consequences, see *infra* Section 3.3.2.

[177] Bratton, *supra* note 148, at 876–77 (asserting that, like OMRs, special dividends provide flexibility to disgorge temporary cash flows without committing to a permanent increase since distinguishing special dividends from regular dividends by stating them as special informs shareholders that repetition should not be expected).

[178] Harry DeAngelo et al., *Special Dividends and the Evolution of Dividend Signaling*, 57 J. FIN. ECON. 309 (2000) (finding that there is a time gap between the decline of special dividends and the rise of OMRs and arguing that this time gap complicates the substitution hypothesis between special dividends and OMRs). However, the decline of special dividends corresponds with the rise of regular dividends in 1970s, which might have been mainly due to the preference of institutional shareholders for regular dividends, and after that, OMRs were widely used as a payout method alternative to regular dividends in 1980s. In other words, notwithstanding special dividends were not directly replaced by OMRs, special dividends might have been indirectly replaced by OMRs through regular dividends in due course.

[179] *Id.* (explaining the survival of larger special dividends with their sheer size that automatically differentiates them from regular dividends).

be that the transaction cost of dividends is fixed, while the transaction cost of OMRs depends on the amount of shares to be repurchased.[180] Hence, OMRs seem to be a more cost-effective method for distributing non–recurring excess cash flows than (special) dividends only when the distributable amount is relatively small.[181] For this reason, the flexibility associated with OMRs could only be a trivial factor contributing to the increase in the number of OMRs.

1.4 Increasing Market Liquidity

Unlike dividends, share repurchases (including OMRs) may increase market liquidity that would help shareholders to trade their shares easily and cheaply by reducing costs incurred by shareholders.[182] Shareholders usually trade via market makers, who compensate their costs and make profits through bid-ask spread, namely by offering to buy certain securities at the bid price and sell them at the ask price that is higher than the bid price.[183] In case of OMR announcements, corporations signal that they might appear as buyers on the market and create a demand for their own shares—the demand which would make trading cheaper for market makers by mitigating their inventory costs that are associated with holding shares.[184] Moreover, actual OMRs may also elicit a narrower bid-ask spread that enables shareholders to trade more cheaply and easily so that the

[180] Fried, *supra* note 43, at 1338 (arguing that, if the amount distributed is sufficiently large, a dividend is likely to involve lower per–dollar transaction costs than a repurchase).
[181] *Id.*
[182] *Id.* at 1339–40.
[183] *Id.*
[184] Ajai Singh et al., *Liquidity Changes Associated with Open Market Repurchases*, 23 FIN. MGMT., Spring 1994, at 47 (arguing that corporations, by announcing OMR plans, signal that they will compete with market makers in reacquisition of shares by means of OMRs that would result in greater liquidity and lower bid-ask spread in the absence of information asymmetry, and also arguing that a direct consequence of OMR announcements may be increased trading in the secondary market).

market becomes more liquid.[185]

However, OMRs may also have the effect of reducing market liquidity, if insiders of a corporation trade in the opposite direction of the repurchasing corporation and sell their own shares at inflated prices.[186] This is because insider trading activity in the opposite direction of OMRs based on an information asymmetry would cause market makers to incur losses due to adverse selection and also increase their inventory holding costs that are associated with holding the unsold shares.[187] Increased costs would force market makers to compensate for their losses by increasing the bid-ask spread. The increased bid-ask spread would in turn increase trading costs of shareholders and reduce the market liquidity.[188] In other words, OMRs may increase market liquidity only when corporations and insiders do not trade in the opposite direction based on superior information around OMRs.

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[185] *Id.* (arguing that actual OMRs would also cause an increase in trading in the secondary market that makes it easier for market makers to reverse their position in the stock and to reduce their inventory holding costs and thereby the bid-ask spread). *See also* Douglas O. Cook et al., *On the Timing and Execution of Open Market Repurchases*, 17 REV. FIN. STUD. 1463 (2004) (finding that share repurchases contribute to market liquidity by narrowing bid-ask spreads and attenuating the price impact of order imbalances on days when repurchase trades are completed).

[186] For the adverse effect of OMR announcements on market liquidity, see Michael J. Barclay & Clifford W. Smith, Jr., *Corporate Payout Policy: Cash Dividends versus Open Market Repurchases*, 22 J. FIN. ECON. 61, 66 and 71 (1988) (finding that bid-ask spreads widen, and liquidity is reduced following OMR announcements and arguing that this is mainly because OMR announcements provide managers with opportunities to use inside information to trade at favorable prices and benefit themselves at the expense of shareholders). For the adverse effect of actual OMRs on market liquidity, see Alice A. Bonaimé & Micheal D. Ryngaert, *Insider Trading and Share Repurchases: Do Insiders and Firms Trade in the Same Direction?*, 22 J. CORP. FIN. 35 (2013) (observing that quarters, in which repurchases are the highest, are associated with net insider selling and illiquidity and arguing that insider selling at the time of a repurchase indicates that managers might be using repurchases to reduce their holdings at a favorable price by supporting share price levels).

[187] Fried, *supra* note 43, at 1361–62.

[188] *Id.*

1.5 Supplying Shares for DRIPs

OMRs may supply shares for dividend reinvestment plans (DRIPs).[189] Corporations may offer DRIPs to their shareholders, who enroll in the plan, to simplify the process for them to reinvest their dividends back to corporate shares instead of getting paid in cash. This simplified process offers various benefits to shareholders that include immediate investment for faster compounding, no brokerage fees and little or no investment transaction fees, the availability of fractional shares that enable shareholders to invest without saving cash for a full share, and the potential for access to discounted share prices offered by certain corporations. On the other hand, enrolling in DRIPs would cause shareholders to have a less diversified portfolio and a less flexible investment, and to continue to pay taxes for cash dividends without receiving cash. Hence, DRIPs seem more suitable for long-term shareholders.

Corporations may either issue new shares or repurchase their own shares via OMRs in order to supply shares for DRIPs. Although new equity issuances also increase the firm's capital to finance growth projects, most corporations prefer to execute OMRs to supply shares for DRIPs.[190] In these cases, the dollar value of OMRs executed for this particular purpose would be equal to cash dividends paid to shareholders, which would cancel each other out. Thus, the increasing use of OMRs in supplying shares for DRIPs in the twenty-first century causes the difference between the

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[189] Purchases of Certain Equity Securities by the Issuer and Others, Exchange Act Release No. 61,414, 75 Fed Reg. 4713 (proposed Jan. 29, 2010).

[190] This preference might be driven by characteristics of corporations executing OMRs for the purpose of having shares for DRIPs in that they are likely to be larger corporations that have free cash flow that needs to be disbursed rather than raising additional capital and have employee and executive stock options, the dilutive effects of which need to be offset via OMRs. For further information on the function of OMRs to offset dilution, see the following Section 1.6.

number of dividends and OMRs to increase in favour of OMRs. Hence, this function of OMRs appears as one of the contributing factors to the precedence of OMRs over dividends.

1.6 Offsetting Stock Dilution

Unlike dividends, OMRs reduce the number of outstanding shares and enable corporations to offset stock dilution. Stock dilution occurs when corporations issue equities for various purposes.[191] Equity issuances increase the number of outstanding shares and cause stock dilution that in turn decreases share value and EPS, and ownership percentage and voting power of shareholders. Thus, shareholders would not favour stock dilution, and corporations would want to offset stock dilution in order to cater to their shareholder preferences. Corporations may offset dilution through share cancellations and share repurchases. Share cancellations are made on a pro rata basis with the participation of all shareholders. For this reason, share cancellations are subject to a special procedure that usually requires the approval of supermajority of shareholders. On the other hand, corporations may repurchase their own shares without the approval of supermajority of shareholders since share repurchases do not compel shareholders to tender their shares. Unlike in the case of share cancellations, corporations also have the right to keep repurchased shares in treasury and reissue them when necessary. Consequently, offsetting stock dilution appears as a crucial reason for managers to execute share repurchases.[192] This finding leads this dissertation to review the potential functions of share repurchases with respect to stock-based compensation of

[191] For these purposes, see *supra* Section 1.5 and see *infra* Section 2.1 and Section 5.
[192] Brav et al., *supra* note 155, at 515 (reporting that two-thirds of executives feel that offsetting dilution is an important or very important factor affecting their repurchase decisions).

executives, the use of which has been one of the main reasons for stock dilution.[193]

2. Bolstering Executive Compensation

Like cash distributions to shareholders, stock-based pay would also mitigate agency problems by aligning interests of managers with those of shareholders. This is because stock-based pay links management compensation to the share price and EPS performance of a corporation. This linkage incentivizes managers to prioritize policies including share repurchases that would increase share prices and EPS and ultimately enhance shareholder value. Indeed, the use of stock-based pay has increased dramatically in the 1990s, with stock options and stock awards now comprising the largest part of total executive compensation,[194] and the dramatic increase in the number of stock-based pay coincided with the dramatic increase in the number of share repurchases, and particularly OMRs, over the same period.[195]

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[193] Scott J. Weisbenner, *Corporate Share Repurchases in the 1990s: What Role Do Stock Options Play?* (Fin. & Econ. Discussion Series, Working Paper No. 29, May 2000), *available at* http://www.federalreserve.gov/pubs/feds/2000/200029/200029pap.pdf (arguing that some corporations may opt to repurchase shares to avoid the dilution of EPS that may result from past stock option grants); Amy K. Dittmar, *Why Do Firms Repurchase Stock?*, 73 J. BUS. 331, 333 (2000) (arguing that firms also repurchased stock to counter the dilution effects of stock options during the late 1980s and early 1990s, during which the use of management stock options increased, and thus more firms may have preferred repurchases to dividends); Kathleen M. Kahle, *When a Buyback Isn't a Buyback: Open Market Repurchases and Employee Options*, 63 J. FIN. ECON. 235 (2002) (arguing that firms announce repurchases when executives have large numbers of options outstanding, which is consistent with managers repurchasing to maximize their own wealth); Daniel A. Bens et al., *Employee Stock Options, EPS Dilution, and Stock Repurchases*, 36 J. ACCT. & ECON. 51 (2003) (finding that managers increase the level of share repurchases when the dilutive effect of outstanding stock options on diluted EPS increases and earnings are below the level required to achieve the desired rate of EPS growth).

[194] *See supra* note 138 and accompanying text.

[195] Christine Jolls, *Stock Repurchases and Incentive Compensation* (Nat'l Bureau of Econ. Res., Working Paper No. w6467, Mar. 1998), *available at* http://ssrn.com/abstract=226212 (stating that the increased use of repurchases coincided with an increasing reliance on stock options to compensate top managers). Weisbenner, *supra* note 193 (stating that employee stock options are associated with increased share repurchases and increased total payouts); George W. Fenn & Nellie Liang, *Corporate Payout Policy and Managerial Stock Incentives*, 60 J. FIN. ECON. 45 (2001) (finding that management stock options are related to the composition of payouts, and that there is a strong

That is likely because share repurchases have multiple effects that would benefit managers directly and shareholders indirectly. First, share repurchases supply shares for corporations to meet their obligations arising from stock options and stock awards allocated to managers. Second, share repurchases increase share prices and EPS, to which stock options and stock awards are tied, and entitle managers to stock options and stock awards. Hence, this section endeavours to examine the multiple functions of share repurchases with respect to executive compensation.

2.1 Supplying Shares for Stock Options and Stock Awards

Corporations may repurchase their own shares and reissue repurchased shares to supply shares for stock options and stock awards allocated to corporate executives.[196] This particular function makes share repurchases a convenient alternative to new equity issuances. A corporation might be unable to issue new equities if the corporation has no authorized but unissued shares and its charter limits new equity issuances, in which case the charter needs to be amended and shareholder approval is required for making such amendment.[197] There is no such costly and time-consuming procedure for corporations to repurchase their own shares and later reissue shares repurchased, especially in the case of OMRs.[198] Moreover, OMRs allow corporations to repurchase their own shares at the market price, which might be cheaper than the alternative methods. For these reasons, corporations

negative relationship between dividends and management stock options and a positive relationship between repurchases and management stock options); Kahle, *supra* note 193, at 236, 260 (2002) (finding that changes in compensation policy in the 1990s, in particular the growing use of stock options by corporations, have caused changes in payout policy towards repurchases).

[196] Fried, *supra* note 43, at 1339.

[197] *Id.*

[198] Managers may easily execute OMRs after the board authorizes them to have the corporation repurchase shares and the corporation announces the board authorization along with the OMR plan to the public via stock exchanges.

would prefer share repurchases, and particularly OMRs, over new equity issuances in order to supply shares for stock options and stock awards.

2.2 Entitling Managers to Stock Options and Stock Awards

Contrary to dividends that may reduce the value of stock options held by managers, share repurchases led by OMRs would also entitle managers to stock options and stock awards by inflating share prices and EPS.[199] First, share repurchases, apart from their information content that potentially increases market demand and thereby share prices, increase marginal price of shares by allowing corporations to repurchase their own shares from shareholders, whose share valuation is lower.[200] Second, by reducing the number of outstanding shares, actual repurchases increase share prices as well as EPS.[201] On the other hand, executive compensation schemes largely comprise of stock-based pay that has been tied to certain share price and EPS targets in quarterly earnings reports. Thus, the inflationary effect of share repurchases on these metrics

[199] Jolls, *supra* note 195 (arguing that stock options encourage managers to choose repurchases over conventional dividend payments because repurchases, unlike dividends, offset dilution of the per–share value of the stock); Weisbenner, *supra* note 193 (arguing that executives may prefer distributing cash by repurchasing shares, as opposed to increasing dividends, to enhance the value of their own stock options); Kahle, *supra* note 193, at 241–42, 260 (finding that in the 1990s, stock options have encouraged firms to repurchase shares to not only supply shares for stock options but also maximize managerial wealth because repurchases do not decrease the value of stock options, whereas dividends do so unless stock options are protected).

[200] Stout, *supra* note 158, at 489–90.

[201] EPS is calculated by dividing a corporation's net income with the number of its outstanding shares. OMRs increase EPS by reducing the denominator. However, it should be noted that increasing EPS by reducing the number of outstanding shares instead of increasing earnings is financial engineering rather than value creation and thereby serves the purpose of earnings management that might mislead investors. *See* Kahle, *supra* note 193, at 240 (arguing that share repurchases reduce the number of outstanding shares, while cash used to repurchase shares reduces paid-in capital, but is not deducted from earnings so that by repurchasing shares in conjunction with option exercises, firms are able to avoid the dilution of basic EPS that would occur if shares outstanding increased); Daniel A. Bens et al., *supra* note 193 (finding that repurchase decisions of managers are driven by incentives to manage diluted EPS that strengthen their earnings management interpretation).

would entitle managers to greater performance-based stock options and stock awards. Accordingly, instead of issuing new equity, corporations may repurchase their own shares to supply shares for stock options and stock awards and to offset dilution caused by stock options and stock awards. In the meantime, share repurchases increase share prices and EPS and entitle managers to stock options and stock awards that are tied to share prices and EPS. Thus, the combination of stock-based compensation and share repurchases led by OMRs form a spiral pattern that substantially contributes to the dramatic increase in the number of OMRs.

3. Facilitating Corporate Finance

Share repurchases are essentially financial tools that would provide managers financial leverage to increase the value of the corporation, particularly for the shareholders, who do not tender their shares within share repurchase programs. First, share repurchases make it easier for managers to alter a corporation's capital structure, namely the debt-equity ratio, especially when share repurchases are financed via debt. An increase in debt would also benefit shareholders. Yet, a higher level of debt would constrain managers by reducing discretionary cash surplus and thereby mitigate agency costs.

Second, share repurchases, and particularly OMRs, enable corporations to invest in their own shares when they are undervalued. Accordingly, a corporation may announce OMRs when managers think shares are undervalued and the perceived undervaluation might persist even after the OMR announcement.[202] In this case, the corporation may go on to execute OMRs to repurchase

[202] *See supra* Section 1.2.

its own shares at the market price and end up investing in its own shares that are thought to be undervalued. Repurchasing undervalued shares would benefit corporations and their non–selling shareholders. This section examines these benefits of share repurchases, and particularly OMRs, with respect to corporate finance, reviews criticism against the use of OMRs for these purposes and suggests under what circumstances it makes sense to execute OMRs for these purposes.

3.1 Altering Capital Structure

While it has been very complex to set an adequate model of optimal debt-equity ratio, managers may want to adjust the leverage ratio based on their predictions about potential changes that might affect the finances of the corporation.[203] According to the optimal leverage ratio hypothesis, managers of a corporation, the leverage ratio of which is below its target leverage ratio, are more likely to have the corporation repurchase its own shares.[204] First, share repurchases absorb equity, and by doing so, decrease the number of outstanding shares and mitigate future obligations to distribute cash to shareholders.[205] Moreover, share repurchases may also be financed with debt,[206] and the effect of debt-financed share repurchases on debt-equity ratio would be particularly strong, since equity would decrease at the same time as debt would increase.

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[203] Laurie Simon Bagwell & John B. Shoven, *Share Repurchases and Acquisitions: An Analysis of Which Firms Participate*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 191 (Alan J. Auerbach ed., 1988).
[204] *Id.*
[205] *Id.* (arguing that both cash dividends and repurchases absorb equity but repurchases are better for a transitional change in capital structure as corporations increasing dividends face with negative return on share price when they later cut dividends). For further information on the negative impact of dividend cuts, *see supra* Section 1.2.
[206] For the percentage of debt-financed repurchases to total repurchases, see GARY SHORTER, CONG. RES. SERV., STOCK BUYBACKS: CONCERNS OVER DEBT-FINANCING AND LONG-TERM INVESTING (Dec. 19, 2019), *available at* http://www.everycrsreport.com/reports/IF11393.html (arguing that a large number of buybacks have been financed by debt despite stating that reported data on the percentage of leveraged buybacks are inconsistent).

Debt-financed share repurchases also offer tax advantages in that the interest rate payment can be reflected as an expenditure that would be deducted from revenues, thus reducing tax obligations.[207] Moreover, multinational corporations generating cash overseas may use debt-financed share repurchases to gain another tax advantage by avoiding repatriation taxes. Repatriation taxes are imposed by the US government on the return of cash that multinational corporations make overseas back to the US. Accordingly, these corporations may leverage overseas cash to take on debt with lower interest rates because of creditors' trust of overseas cash, and use debt to finance share repurchases. Thus, multinational corporations use share repurchases as well as (special) dividends to distribute overseas cash to their shareholders without having to pay repatriation tax.[208]

Share repurchases may also benefit corporations that would like to issue equity and alter their capital structure the other way around. Recalling that share repurchases may increase market liquidity, increased market liquidity would reduce the cost of raising capital via seasoned equity offerings by encouraging investors to purchase newly issued shares,[209] and enabling corporations to pay significantly lower fees to investment banks.[210] These functions of share repurchases suggest that a corporation's capital structure may affect its decision to repurchase.[211]

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[207] Bagwell & Shoven, *supra* note 200, at 194–95.
[208] Kitty Richards & John Craig, *Offshore Corporate Profits: The Only Thing 'Trapped' is Tax Revenue*, CENTER FOR AM. PROGRESS (Jan. 9, 2014), http://www.americanprogress.org/issues/economy/reports/2014/01/09/81681/offshore-corporate-profits-the-only-thing-trapped-is-tax-revenue.
[209] Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation,* 81 VA. L. REV. 611, 683–84 (1995).
[210] Alexander W. Butler et al., *Stock Market Liquidity and the Cost of Issuing Equity,* 40 J. FIN. & QUANTITATIVE ANALYSIS 331 (2005).
[211] *See also* Brav et al., *supra* note 153, 508 tbl.8 (reporting that more than one-fourth of firms states that adjusting the debt-to-equity ratio is an important or very important factor affecting their repurchase decisions).

3.2 Investing in Undervalued Shares

Actual OMRs enable corporations to repurchase their own shares at prevailing market prices. Hence, corporations would be able to invest in their own shares via actual OMRs when managers perceive that shares are undervalued, namely that the market price is lower than the book value.[212] This particular function of actual OMRs occurs only when corporations repurchase their own shares that remain undervalued even after OMR announcements.[213] Therefore, a corporation's decision to invest in its own shares via actual OMRs financially makes sense only when managers time the market and repurchase shares when the market-to-book ratio (the rate of market price to book value of shares) is materially low based on conservatively made financial calculations.[214] Moreover, even if shares to be repurchased are undervalued, managers must also ensure that there

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[212] Brav et al., *supra* note 153, at 517 (reporting that nearly 90% of firms with low P/E ratios state that market undervaluation could lead to repurchases).

[213] OMR announcements may fail to increase share prices (as much as managers would anticipate) because the market might simply miscalculate these announcements or disagree with managers that think that shares are undervalued. *See* Gustavo Grullon & Roni Michaely, *The Information Content of Share Repurchase Programs,* 59 J. FIN. 5651 (2004) (finding evidence to indicate that investors underreact to repurchase announcements because they initially underestimate the decline in cost of capital); Urs Peyer & Theo Vermaelen, *The Nature and Persistence of Buyback Anomalies,* 22 REV. FIN. STUD. 1693 (2009) (finding evidence that corporations use OMRs to respond to market overreaction to bad news such as analyst downgrades and overly pessimistic forecasts, and concluding that the market thus continues to underreact to OMR announcements as documented in Ikenberry, Lakonishok & Vermaelen (1995) and such underreaction is consistent with the survey results of Brav et al. (2005) implying that firms repurchase stock when their shares are undervalued). For another potential reason for why OMR announcements fail to increase share prices, see Bhattacharya & Jacobsen, *supra* note 162 (developing a theoretical model that predicts that OMRs announcements fail to attract speculators and increase share prices when shares are undervalued by a small margin, and in these cases, corporations will need to actually repurchase their own shares). On the other hand, corporations might have a track record of false signalling, namely they may frequently announce OMRs that are not followed by actual OMRs, that might discount the market reaction to OMR announcements. There might also be psychological reasons, namely the limited attention power and overconfidence contributing to investor credulity, that would cause investors to underreact to OMR announcements and/or overreact to bad news. *See* Kent D. Daniel et al., *Investor Psychology in Capital Markets: Evidence and Policy Implications*, 49 J. MONETARY ECON. 139, 178 (2002).

[214] Richard Fields, *Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution*, THE INV. RESP. RES. CENTER INST. & TAPESTRY NETWORKS 14 (Aug. 2016), http://www.tapestrynetworks.com/publications/irrc-institute-buybacks-and-the-board.

exist no other investment opportunities, the expected return of which would be higher than the expected return of repurchasing undervalued shares over a given time horizon.[215]

Several studies present evidence based on repurchase prices supporting the market timing hypothesis and claim that managers can time the market and repurchase undervalued shares.[216] However, other studies rely on macroscale data on the amount of shares repurchased and find that the repurchasing activity inherently follows the economic cycle and decreases following adverse market conditions and thereby claim that managers mistime OMRs.[217] Such mistiming would

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[215] Ralph Atkins, *Will Share Buyback Craze Spread to Europe?*, FIN. TIMES, May 28, 2015, http://www.ft.com/content/c469c1f4-047b-11e5-95ad-00144feabdc0 (arguing that spending on buybacks and dividends is symptomatic of weak long-term growth worries—rather than a cause). However, see *supra* Part D.2.2 for the discussion on whether and how distributing too much cash to shareholders via repurchases would disrupt long-term growth.

[216] Stephens & Weisbach, *supra* note 119 (finding that share repurchases are negatively related to prior stock price performance, suggesting that firms increase their purchasing depending on its degree of perceived undervaluation); Eli Bartov et al., *Evidence on How Companies Choose Between Dividends and Open-Market Stock Repurchases*, 11 J. APPLIED CORP. FIN., Spring 1998, at 89 (claiming that undervaluation is the leading motive for corporations to use OMRs); Jagannathan et al., *supra* note 170 (finding that firms repurchase stock following poor stock market performance); Brav et al., *supra* note 153, at 514 (reporting that 86.4% of all firms agree that firms repurchase when their stock is a good investment, relative to its true value, and about one-half of the executives say that their firm tracks repurchase timing and that their firm can beat the market, some say by $1 or $2 per share over the course of the year); Ben-Rephael et al., *supra* note 159 (finding that corporations repurchase their own shares at prices significantly lower than average market prices and that this price discount is negatively related to size and positively related to market-to-book ratio); Amy Dittmar & Laura Cesares Field, *Can Managers Time the Market? Evidence Using Repurchase Price Data*, 115 J. FIN. ECON. 261 (2015) (finding that firms repurchase stock at a significantly lower price than the average market price).

[217] William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 686 n.117 (2010) (stating that the financial crisis materially chilled buyback activity in 2008 with a 42.3% drop from the previous year); Ben Steverman, *The Incredible Shrinking Stock Buyback*, BLOOMBERG BUS. WK., June 19, 2009, http://www.bloomberg.com/news/articles/2009-06-18/the-incredible-shrinking-stock-buyback (citing that S&P 500 firms bought back a record $172 billion in shares in the third quarter of 2007 when stocks were near their all-time peak); Bin Jiang & Tim Koller, *The Savvy Executive's Guide to Buying Back Shares*, MCKINSEY & COMPANY (Oct. 1, 2011), http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-savvy-executives-guide-to-buying-back-shares (finding that a majority of corporations repurchased shares when they and the market were both doing well and were reluctant to repurchase shares when prices were low relative to their intrinsic value, and few corporations stopped repurchases even as the market peaked in 2007 and few corporations bought back shares when the market bottomed in 2009). Mistimed OMRs are likely to result in transfer of value from the corporation and their stakeholders including non–selling shareholders to selling shareholders. For further information on the adverse effects of mistiming OMRs, see *infra* Part D.1.1.2.

result in corporations repurchasing shares when they are not undervalued and/or missing the opportunity to buy the dip. On the other hand, notwithstanding executives claim that shares are repurchased only in the absence of profitable investment opportunities,[218] several studies claim that decisions to repurchase (undervalued) shares via actual OMRs result in value destruction by causing corporations to forego positive NPV investment projects.[219]

This particular function of actual OMRs has also been criticized for conflicting with the fundamental assumptions of modern finance. First, managerial decisions to repurchase undervalued shares via actual OMRs contradict with the rational choice theory. Yet, managers, as rational investors, who perceives that shares are undervalued, would be expected to purchase undervalued shares with their own wealth rather than corporate cash.[220] The second criticism for managerial decisions to invest in a corporation's undervalued shares has been that the assertion that managers can time/beat the market contradicts with the efficient capital market hypothesis.[221]

4. Deterring Hostile Takeover Attempts

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[218] Brav et al., *supra* note 153, at 490–97 (reporting that 80% of executives state that the availability of good investment projects is an important factor affecting repurchase decisions in that repurchases are made in the absence of profitable investment opportunities).

[219] For further information on whether, why, and how corporations would execute repurchases at the expense of promising investment opportunities, see *infra* Part D.2.

[220] Fried, *supra* note 39. However, there might be a number of legal and financial factors that would partly or completely inhibit managers from purchasing shares on their own behalf and prompt them to combine or replace their net insider buying with bargain repurchases. Managers, though to a lesser extent, would also benefit from such bargain repurchases via indirect insider trading. For further information on managers' choice between direct and indirect insider trading, see *infra* Part D.1.1.2.

[221] Fields, *supra* note 214, at 15.

Corporations may announce OMR plans and execute OMRs to deter potential takeover bidders in anticipation of hostile takeover attempts,[222] whereas self-tender offers act as a defense in the midst of a takeover attempt.[223] This is because the price offered in a self-tender offer is typically at a premium over the market price to induce shareholders to tender their shares to the corporation as opposed to the tender offer made by the hostile bidder. On the other hand, corporations repurchase their own shares at the market price through OMRs.

OMRs contain the deterrence effect for several reasons. First, OMRs cause shareholders with the lowest reservation values to sell their shares. These sales would, in turn, raise the share price of target corporations and make the cost of potential acquisition more expensive. Such increase in price would force potential bidders to either make a higher offer or abandon the fight.[224] Second, OMRs cause shareholders to tender their shares within an OMR program, who might otherwise tender their shares to hostile bidders. Repurchasing shares from shareholders that are inclined to sell would increase the ownership percentage of insiders as well as those who favour insiders and are unlikely to tender. Such increase in ownership would enhance the probability that the bid will

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[222] Matthew T. Billett & Hui Xue, *The Takeover Deterrent Effect of Open Market Share Repurchases*, 62 J. FIN. 1827, 1845 (2007) (arguing that OMRs have a takeover deterrent effect based on the finding that OMR activity increases when corporations face a high takeover probability).

[223] *Id.* at 1830. In this regard, the SEC has established two distinct rules by distinguishing share repurchases depending on their timing. While OMRs executed in normal course have been subject to the Rule 10b-18 and falls within the scope of this dissertation, share repurchases that are executed during third party tender offer, namely self-tender offers, have been subject to another rule, namely the Rule 13e-4, that prescribes a stricter regime than that under the Rule 10b-18. For a critical analysis on the regulatory treatment of all defensive share repurchases including OMRs, see Michael Bradley & Michael Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377, 1399 (1986).

[224] Laurie Simon Bagwell, *Share Repurchase and Takeover Deterrence*, 22 RAND J. ECON. 72 (1991) (arguing that if the target firm repurchases its own shares in the presence of an upward-sloping supply curve for shares, the takeover cost to the acquirer can be greater because shareholders willing to tender in the repurchase are systematically those with the lowest valuations, and the repurchase skews the distribution of remaining shareholders toward a more expensive pool).

fail.[225] Third, squandering cash through OMRs and adding debt to finance OMRs, if OMRs are financed by debt, make target corporations less attractive for bidders, who see targets as attractive cash hoards.[226] Lastly, the deterrence effect of actual OMRs also makes announcements of OMR plans act as a deterrent to potential acquirers because these announcements enable target corporations to quickly respond to possible takeover attempts by allowing them to repurchase shares at any time.[227]

The takeover deterrent effect of OMRs seems to primarily benefit managers. Yet, OMRs help management to either intercept possible takeover attempts and retain their positions, or force bidders, with or without initiating a bidding contest, to make higher bids. Defensive OMRs that would result in potential acquirers to make a higher bid would also benefit shareholders. However, assuming that the potential takeover would create value for shareholders, defensive OMRs that have the effect of intercepting such value-creating takeover attempts would be detrimental to shareholders. Indeed, since defensive OMRs are typically executed to deter potential acquirers in advance of a possible takeover attempt, they inevitably prevent shareholders from being informed about the potential bid. Thus, the managerial entrenchment hypothesis appears as a more plausible explanation for why managers would want to execute OMRs for defensive purposes. Notwithstanding that the use of OMRs for the purpose of deterring potential bidders explain much

[225] Billett & Xue, *supra* note 218, at 1830.
[226] *Id.*
[227] *Id.*

of the OMR activity in the mid–1980s when the takeover market was very active,[228] it now appears as a less significant reason for managers to execute OMRs.[229]

5. Supplying Shares for ESOPs

Corporations may also execute share repurchases to supply shares for ESOPs.[230] ESOPs are one of the financial participation schemes for employees. ESOPs give employees ownership interests in corporations to promote a sense of commitment to the corporation, increase productivity, and above all, to tie a fraction of employee compensation to share price performance to align the interests of employees with those of shareholders. To that effect, ESOPs seem crucial in jurisdictions like the US, in which employees have weak representation rights and corporations seek to maximize share value.[231] ESOPs also provide tax advantages to employees and corporations, although they cause employees to invest all their stakes into the shares of the same corporation and thereby lose the protection of a diversified investment portfolio.[232] For these reasons, US corporations widely offer ESOPs so that they would have to supply shares for ESOPs. In this context, share repurchases, and particularly OMRs, appear convenient alternatives to new

[228] Amy K. Dittmar, *supra* note 193, at 333, 347–49 (suggesting that corporations repurchase stock to fend off takeover attempts during periods of high merger activity and this partly explains the increase in volume and number of repurchases in the mid–1980s).
[229] Brav et al., *supra* note 153, 508 tbl.8 (reporting that only 14.1 percent of executives feel that accumulating shares to resist a potential takeover bid is an important or very important factor affecting repurchase decisions).
[230] Kahle, *supra* note 193 (finding that corporations announce repurchases when employees have large numbers of options currently exercisable that is consistent with managers execute repurchases to fund employee stock option exercises).
[231] Aguilera & Jackson, *supra* note 26, at 455–56.
[232] Sean M. Anderson, *Risky Retirement Business: How ESOPs Harm the Workers They Are Supposed to Help,* 41 LOY. U. CHI. L.J. 1 (2009) (arguing that ESOPs, as a special form of retirement plan that invests primarily in shares of employers, cause employees to stick with under–diversified retirement savings, which expose them to unnecessary levels of investment risk).

equity issuances in supplying shares for ESOPs and to share cancellations in offsetting dilution caused by the exercise of employee stock options.[233]

D. Potential Drawbacks Arising from the Abuse of OMRs in the US

While OMRs can be executed for a number of seemingly legitimate purposes examined above, they can simultaneously be used for illegitimate purposes, which can easily be concealed beneath legitimate purposes.[234] This is because both OMR announcements and actual OMRs are potentially manipulative. First, announcements of OMR plans often inflate share prices and do not oblige corporations to actually repurchase their own shares. Second, actual OMRs definitely inflate share prices and enable corporations to repurchase their own shares at the market price while distributing cash to shareholders not on a pro rata basis. That is to say, the combination of the inflationary and non–obligatory nature of OMR announcements and the inflationary, bargain, and disproportionate nature of actual OMRs makes OMRs open to market abuse.

In this context, such combination primarily enables managers having access to inside information to take advantage of information asymmetries and obtain benefits from direct and indirect trades at the expense of the less-informed shareholders that are on the other side of the trade.[235] Similarly, active institutional shareholders, who have access to information superior to that available to less-informed shareholders, can also time their trades to obtain private benefits via OMRs at the

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[233] *See supra* Sections 1.6 and 2.1.

[234] Gina-Gail S. Fletcher, *Legitimate Yet Manipulative: The Conundrum of Open-Market Manipulation*, 68 DUKE L.J. 479 (2018) (stating that open market transactions are entirely facially legitimate transactions executed on the open market, but they may be manipulative at the same time).

[235] This part uses the term managers to denote directors and officers. Directors have the sole authority to authorize officers to execute OMRs and officers have the exclusive authority to execute OMRs.

expense of the less-informed shareholders. Ultimately, potential transfer of value from those having less information to those having access to inside or superior information would harm markets by undermining investor confidence in the absence of effective legal measures.[236]

The ability of those having access to inside or superior information to exploit OMRs may also harm corporations and corporate stakeholders having long-term interests. Yet, managers, whose compensation is largely tied to share price performance via quarterly earnings reports, tend to adopt short-term policies including OMRs to enhance share prices.[237] On the other hand, certain kinds of active institutional shareholders, who not only actively monitor management but also engage in corporate governance and business decisions of corporations, particularly shareholder activists that typically use hedge funds as vehicles, tend to influence managers on adopting short-term policies including OMRs that would meet short-term financial interests of their investors.[238] Hence, the interests of managers and short-term shareholder activists with respect to OMRs seem to have been aligned. Their aligned interests are likely to result in corporations executing excessive number of OMRs that would cause underinvestment and ultimately harm corporations and corporate stakeholders including long-term shareholders.[239]

To discuss these points, this part consists of two sections. The first section explains how OMRs carry the potential risk of being exploited by managers as well as active institutional shareholders through market manipulation and informed trading at the expense of less-informed shareholders. The second section suggests that OMRs would also have adverse consequences since the potential

[236] *See infra* Section 1.
[237] See *infra* Section 2.1.
[238] *Id.*
[239] *See infra* Section 2.2.

alignment of short-term interests of managers and short-term shareholder activists with respect to OMRs might cause corporations to excessively execute OMRs, which would lead to underinvestment that would harm corporations and their stakeholders having long-term interests.

1. Market Manipulation and Informed Trading via OMRs

Corporate stakeholders that have inside or superior information may exploit OMRs at the expense of less-informed shareholders. These stakeholders are led by managers, who have access to inside information regarding the finances of corporations and take OMR-related corporate actions. Managers, subject to certain legal limitations imposed by securities laws,[240] are able to trade on their own shares and also exercise their options, which are tied to share prices and EPS that could be inflated by OMRs. Consequently, OMRs enable managers to engage in manipulation and take advantage of inside information and obtain benefits from their trading decisions at the expense of the less-informed shareholders that are on the other side of the trade.[241] The potential of market manipulation and insider trading via OMRs has long been acknowledged by the SEC as well. However, the SEC have understated the potential of exploitation of OMRs and taken a regulatory

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[240] The limitations on insider trades include Rule 144 of the Securities Act of 1933 [17 C.F.R. § 230.144 (2019)] that prescribes a non-exclusive safe harbor rule that allows insiders to publicly trade restricted and control securities as long as they comply with a number of conditions stated in the rule, and Rule 10b-5 that covers instances of insider trading by prohibiting any person from directly or indirectly by employing practices to defraud, make false statements, mislead by omitting material information, or otherwise conduct business operations that would deceive another person in the process of purchase and sale of any security.

[241] Barclay & Smith, *supra* note 182 (arguing that OMRs, unlike dividends, provide managers with opportunities to use inside information to benefit themselves at the expense of shareholders based on the evidence suggesting that bid-ask spreads widen around repurchase announcements); Fried, *supra* note 39, at 881 (arguing that managers use OMRs not for the benefit of shareholders, but, rather, to maximize their own wealth, even at the expense of public shareholders).

approach that seems to have been ineffective in inhibiting manipulation and insider trading via OMRs.

Even if not inhibited by law, shareholders can inhibit managers from exploiting OMRs through effective monitoring. However, US corporations typically have dispersed ownership so that shareholders including many institutional shareholders hold less than the 10% threshold and fall outside the definition of controlling shareholder and thereby of the scope of insider trading requirements. On the other hand, institutional shareholders, which are expected to suffer less from rational apathy and actively monitor management, have access to information that some other shareholders would not have. Considering the fact that OMRs, unlike dividends, distribute cash to shareholders not on a pro rata basis, it has been argued that superior information also enables more informed shareholders to time their trades and exploit OMRs at the expense of less-informed shareholders.[242]

Hence, this section consists of two subsections. The first subsection reviews how managers are able to engage in manipulation and insider trading via OMRs. The second section suggests that active institutional shareholders are also able to exploit OMRs by adjusting their trading decisions based on superior information they possess. The potential of exploitation of OMRs by more-informed corporate stakeholders would harm less-informed shareholders and ultimately markets.

[242] Brennan & Thakor, *supra* note 39, at 994, 1015 (concluding that share repurchases cannot distribute cash to shareholders on a pro rata basis due to the differentiation tax treatment of shareholders, and the disproportionate aspect of repurchases, which is not shared by dividends, renders less-informed smaller shareholders vulnerable to expropriation by the better-informed larger shareholders based on the assumption that there is a fixed cost of information acquisition).

1.1 Managers' Ability to Exploit OMRs

OMRs create the risk of market manipulation and insider trading by managers. This risk arises from managerial authority to make business decisions on OMRs as well as trading decisions on their own shares and stock options based on the inside information they have. The combination of all these factors enables managers to buy shares at a discount prior to OMR announcements and actual OMRs, and/or to (exercise their stock options and) sell shares at a premium following these corporate actions at the expense of shareholders, who sell shares at a discount or buy shares at a premium.[243] The risk of market manipulation and insider trading via OMRs is also recognized by securities exchanges and the SEC. However, the regulatory framework seems ineffective because (i) mandatory disclosure requirements are neither detailed nor timely, (ii) the OMR rule is a non-exclusive safe harbor rule and is not directly enforceable,[244] and (iii) insider trading rules are not easily enforceable.[245]

Moreover, managers may reap gains even if they choose not to trade their shares around actual OMRs.[246] This is because managers perceiving that shares are undervalued may execute OMRs, keep their own shares, and reap gains at the expense of selling shareholders. Managers may also exploit OMRs without having to trade on their own shares by means of stock-based executive compensation because OMRs would increase share prices and EPS and entitle managers to stock

[243] *See infra* note 275 and accompanying text.
[244] *See infra* note 270 and accompanying text.
[245] For similar conclusions on the effectiveness of rules applicable to OMRs, see Fried, *supra* note 41, at 1340–43.
[246] Fried, *supra* note 39, at 881–85. *See also* Fried, *supra* note 41, at 1344–51; Jesse M. Fried, *Insider Trading via the Corporation,* 162 U. PA. L. REV. 801, 811–20 (2014).

options and stock awards that are conditioned on certain share price and EPS targets.[247] Therefore, managers would not only be able to make better forecasts regarding finances of the corporation based on inside information but also fine-tune the timing of OMRs and benefit from actual OMRs without actually trading in their own shares. These kinds of indirect insider trades, on the other hand, fall out of the scope of the insider trading rule. Moreover, as noted above, mandatory disclosure requirements on the OMR activity of corporations have not been timely and detailed enough to enable market authorities to monitor trading behaviours of corporations and their insiders around actual OMRs.

Hence, in order to elaborate on how OMRs are exploited by managers at the expense of shareholders, this subsection consists of two paragraphs. The first paragraph examines how managers are able to exploit OMRs to manipulate share price and commit direct insider trading at the expense of shareholders. The second paragraph explains how managers are able to exploit OMRs, even if they do not trade their shares around actual OMRs. By doing that, these subsections also examine whether and why legal remedies against these unlawful practices have been ineffective.

1.1.1 Insider Trading Around OMR Announcements and Actual OMRs

Share prices could be inflated by corporations with two distinct OMR-related actions. The first corporate action is the announcement of OMR plans, which the corporation announces when the

[247] Lazonick, *supra* note 38, at 48 (arguing that OMRs increase the demand for shares of a corporation and automatically lifts its stock price, even if only temporarily, and enable the company to hit quarterly EPS targets). *See* also *supra* Part C.2.2.

board of directors authorizes managers to execute OMRs. Securities exchanges require corporations to promptly disclose the authorization to the public based on the notion that OMR plans are regarded as material non–public information.[248] Yet, OMR plans might inflate share prices because the market usually reacts positively to OMR plans that signal positive information on corporations, namely that corporations have excess cash to be distributed to shareholders and that management perceives that shares are undervalued.[249] On the other hand, OMR announcements do not oblige corporations to actually execute OMRs.[250] That is, OMRs announcements may not be followed by actual OMRs. Notwithstanding that the lack of commitment undermines the credibility and thereby the signalling content of OMR announcements, investors tend to react to announcements of OMR plans positively.[251]

Indeed, the board of directors may authorize managers even when managers have no intention to actually repurchase any shares mainly based on the perception that shares are not undervalued.[252] Considering the strong affiliation between directors and managers in the US, managers would also know when the board of directors authorizes themselves and thereby the timing of OMR announcements and better estimate various factors affecting the level of increase on share price.[253] Inside information enables managers to adjust their trades in a way to avoid selling their shares

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[248] *See, e.g.*, NASDAQ Rule IM-5250-1.

[249] *See supra* Part C.1.2.

[250] *Id.*

[251] Beverly Kracher & Robert R. Johnson, *Repurchase Announcements, Lies and False Signals*, 16 J. BUS. ETHICS 1677 (1997).

[252] Fried, *supra* note 41, at 1352–56 (explaining that the non–obligatory feature of OMR announcements enables managers to engage in false signaling that allows managers to support market prices and exercise their stock options and sell their own shares at a higher price for various reasons).

[253] The mounting evidence of the managers' ability to know about board decisions is the CEO duality, namely the situation when a person serves as both CEO and board member (in many cases, chair of the board). For further information on CEO duality, see generally Ryan Krause et al., *CEO Duality: A Review and Research Agenda,* 40 J. MGMT. 256 (2014).

and even purchase additional shares, if undervalued, on their own account prior to OMR announcements,[254] with the intention of (entitling or exercising stock options and) selling shares at inflated prices following OMR announcements.[255] Consequently, managers may manipulate share prices and engage in unlawful insider trading due to the inflationary and non–obligatory nature of OMR announcements in almost all cases.

Managers may also continue to keep their shares and/or purchase more shares and consider further executing actual OMRs to repurchase shares, especially when OMR announcements fail to affect share prices as much as managers would anticipate and shares remain undervalued.[256] Unlike OMR announcements that potentially increase share prices, actual OMRs definitely increase share prices. First, actual OMRs convey information with the ex post disclosure of actual repurchase data.[257] Second, OMRs distribute cash disproportionately that causes shareholders, who are less-optimistic

[254] Elias Raad & H. K. Wu, *Insider Trading Effects on Stock Returns Around Open-Market Repurchase Announcements: An Empirical Study*, 18 J. FIN. RES. 45, 57 (1995) (arguing that managers directly buy as many shares as they would like on the market before announcing repurchases).

[255] Barclay & Smith, *supra* note 182 (arguing that OMR programs provide managers with opportunities to use inside information to benefit themselves at the expense of shareholders based on the evidence that bid-ask spreads widen around OMR announcements indicating that managers sell their own shares following OMR announcements); Nikos Vafeas, *Determinants of the Choice between Alternative Share Repurchase Methods*, 12 J. ACCT., AUDITING & FIN. 101, 112–13 tbl.1 (1997) (reporting that that a decline from 15.7% to 15% in the percentage of mean insider ownership is observed after OMR announcements); Kahle, *supra* note 193, at 242 (claiming that the positive announcement return associated with repurchases could further increase the wealth of managers planning to exercise options in the near future); Bratton, *supra* note 148, at 872 (citing evidence that firms time repurchase announcements around the times stock options are being exercised); Konan Chan et al., *Share Repurchases as a Potential Tool to Mislead Investors*, 16 J. CORP. FIN. 137 (2010) (arguing that there have been corporations where managers were seemingly under heavy pressure to boost stock prices and might have announced OMR plans not to repurchase stock but only to convey a false signal, and managers in these corporations have comparatively higher exposure to stock options, a potentially endogenous result suggesting greater sensitivity to both stock valuation and to future equity dilution).

[256] *See supra* Part C.3.2.

[257] Ben-Rephael et al., *supra* note 161 (finding that corporations repurchase their own shares at prices significantly lower than average market prices, and repurchase activity is followed by a price increase after disclosure of actual repurchase data in earnings announcements so that insider trading is positively related to actual repurchases).

about share prices, to tender their shares, which would ultimately increase share prices.[258] By doing so, OMRs also reduce the number of outstanding shares and increase share prices and EPS.[259] Moreover, managers are able to time not only OMRs but also voluntary disclosures. Through voluntary disclosures around OMRs, managers are able to manipulate information flows by making negative announcements before actual OMRs and, to a lesser extent, positive announcements after actual OMRs.[260] These announcements increase the price spread before and after actual OMRs, and thereby enable managers to reap more personal gains.[261] Hence, managers are able to buy shares at a discount before actual OMRs (and entitle to or exercise stock options) and sell shares at a premium after actual OMRs.[262]

Consequently, managers, who have access to inside information, are able to exploit both OMR announcements and actual OMRs. Such exploitation comes at the expense of the less-informed shareholders that are on the other side of the trade. That is, prior to these two inflationary OMR-related actions, wealth would be transferred from selling shareholders, who sell their shares at a

[258] Stout, *supra* note 158, at 490 (describing the inflationary effect of actual OMRs as the natural and unescapable consequence of restricting the supply of shares in the face of a downward-sloping demand function).
[259] Bratton, *supra* note 148, at 846.
[260] Paul Brockman et al., *Voluntary Disclosure around Share Repurchases*, 89 J. FIN. ECON. 174 (2008) (finding that managers increase the percentage and magnitude of bad news announcements during the one-month period prior to repurchasing shares, and finding weaker evidence that managers increase the percentage and magnitude of good news announcements during the one-month period following their repurchases-the results are consistent with Barclay and Smith's conjecture that share repurchases, unlike dividends, create incentives for managers to manipulate information flows-and that managers' propensity to alter information flows prior to share repurchases increases with their ownership interest in the firm).
[261] *Id.* at 177, 190–91 (arguing that managers can disclose opportunistically by releasing more bad news prior to initiating repurchases in order to buy back shares at relatively low prices, whereas they can disclose more good news after completing repurchases to reap private benefits and claiming that their results support the managerial opportunism hypothesis in that the growing use of repurchases has increased managers' opportunity to exploit information advantages).
[262] Bonaimé & Ryngaert, *supra* note 186 (observing that quarters, in which repurchases are the highest, are associated with net insider selling and illiquidity).

discount by not knowing the upcoming corporate actions, to non–selling (and buying) shareholders led by managers. Following these corporate actions, wealth generated in this process would be transferred from buying shareholders, who buy shares at a premium by expecting that share prices will further increase, to selling shareholders. In both instances, OMRs do not create value but transfer value, and benefit those having superior information due to adverse selection induced by asymmetrical information. Hence, OMRs, commonly conceived as beneficial to shareholders, might become a drawback for shareholders, particularly for less-informed shareholders.

The risk of manipulation and insider trading via OMRs is recognized by securities exchanges and the SEC as well. First, the potential for manipulation and insider trading arises when corporations announce OMR plans as required by securities exchanges.[263] However, securities exchanges do not usually require corporations to provide further information on OMR plans. The SEC, on the other hand, requires corporations to disclose details of OMR plans,[264] along with information on actual OMRs to be disclosed pursuant to the Rule 10b-18.[265] The rule provides repurchasing corporations a safe harbor in order to keep corporations and their managers free from potential liability under anti–manipulation provisions and the insider trading rule as long as repurchases are executed in accordance with the manner, timing, price, and volume conditions prescribed by the rule.[266] The safe harbor rule is non-exclusive in that failure to meet any of the conditions does not

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[263] *See supra* note 248 and accompanying text.
[264] *See* 2003 Amending Release, *supra* note 44, at 68 Fed. Reg. 64,970, 64,974 (requiring corporations to disclose in the aggregate for all plans or programs publicly announced by footnote to the Item 703 the date each plan or program was announced; the dollar amount (or share or unit amount) approved; the expiration date (if any) of each plan or program; each plan or program that has expired during the period covered by the table; and each plan or program the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases).
[265] *See* Preliminary Notes to the Rule 10b-18.
[266] *See* Rule 10b-18(b).

directly give rise to a presumption that corporations and their insiders violate anti–manipulation provisions or insider trading rules, but only removes repurchases from the safe harbor for that day.[267] Yet, evidence suggests that many corporations do not comply with the Rule 10b-18.[268] On the other hand, in contradiction with the nature of the safe harbor rule, the SEC states that technical compliance with the safe harbor rule does not confer protection from liability if the repurchase activity violates the insider trading rule.[269]

As the then-SEC Chair Mary Jo White has also articulated,[270] the SEC cannot directly enforce Rule 10b-18 in case of suspicion of the potential violation. This is because Rule 10b-18 is a non-exclusive safe harbor rule, compliance with which is voluntary, so that corporations cannot violate

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[267] *See* Rule 10b-18(d).

[268] *See* Cook et al., *supra* note 121, at 309 (documenting that out of 54 corporations, 52 of them traded outside the safe harbor at least once over the course of their repurchase program, whereas twenty-two corporations violated the volume limitations on at least one occasion, and fifty corporations apparently violated the pricing and timing provisions). Moreover, these trading conditions, particularly the volume condition, have been lax. For figures on how much corporations can spend on OMRs per day and still remain within the safe harbor protection, see William Lazonick, *The Fragility of the U.S. Economy: The Financialized Corporation and the Disappearing Middle Class, in* THE THIRD GLOBALIZATION: CAN WEALTHY NATIONS STAY RICH IN THE TWENTY-FIRST CENTURY? 232, 251 (Dan Breznitz & John Zysman eds., 2013) (arguing that under the Rule 10b-18, during the single trading day of, for example, July 13, 2011, a leading repurchasing corporation such as Exxon Mobil could have done as much as $416 million in buybacks, Bank of America $402 million, Microsoft $390 million, Intel $285 million, Cisco $269 million, GE $230 million, and IBM $220 million. Moreover, according to the SEC's rules, buybacks of these magnitudes can be repeated day after trading day).

[269] 1982 Adopting Release, *supra* note 111, at 47 Fed. Reg. 53,334 n.5 (stating that the rule confers no immunity from possible Rule 10b-5 liability where the issuer engages in repurchases while in possession of favorable, material non–public information concerning its securities). *See also* Preliminary Notes to the Rule 10b-18 (stating that the safe harbor is not available for repurchases that, although made in technical compliance with the section, are part of a plan or scheme to evade the federal securities laws). The 2003 Amending Release further explains that the safe harbor provides only that certain, specific provisions of the securities laws will not be considered to have been violated solely by reason of the manner, timing, price, or volume of such repurchases, provided that the repurchases are made within the limitations of the Rule.

[270] Letter from Mary Jo White, SEC Chair, to Tammy Baldwin, Senator 2 (July 13, 2015), http://www.documentcloud.org/documents/2272283-sec-response-to-baldwin-07132015.html#document/p1 [hereinafter referred to as White's Letter]. The letter was written in response to Sen. Tammy Baldwin's inquiry into the SEC's stance on buybacks. *See* Letter from Tammy Baldwin, Senator, to Mary Jo White, SEC Chair (April 23, 2015), http://www.baldwin.senate.gov/imo/media/doc/Baldwin%20Letter%20to%20SEC%204%2023%2015.pdf.

the rule. Rather, violations of the Rule 10b-18 could be addressed under anti–manipulation provisions and the insider trading rule. The SEC is authorized to enforce anti–manipulation provisions and the insider trading rule upon special investigation, in which details of OMRs disclosed by corporations as well as trade disclosures by insiders shall be examined.[271]

However, in practice, the SEC has been unable to enforce anti–manipulation provisions and the insider trading rule with respect to OMRs for economic and legal reasons. First, disclosure requirements regarding OMRs are not detailed and timely to allow the SEC to monitor them,[272] and OMRs have become daily market practices that are frequently executed by corporations, which makes it even more difficult for the SEC to monitor them. Second, even if the SEC is to enforce the insider trading rule with respect to OMRs, the rule is not easily enforceable. The case law under the rule requires persons possessing material non–public information to disclose that information or abstain from trading.[273] However, the bar for materiality of non–public information is so high that it is difficult for the SEC to bring a legal action or start an investigation against insiders that owe fiduciary duty to shareholders and engage in insider trading around OMRs.[274] Finally yet importantly, the SEC Rule 16(b)-6, which has interpreted the Section 16(b) of the Securities

[271] For anti–manipulation provisions and the insider trading rule, see *supra* notes 14–15. The SEC must prove that a manipulative or deceptive practice exists, such practice is material and in connection with the purchase or sale of securities, and perpetrators have such intent. For a critical analysis on the intent-based approach of the SEC with respect to investigations of open market transactions and the recommendation of a harm-based approach, see Fletcher, *supra* note 234.

[272] White's Letter, *supra* note 270, at 3 (citing the mandatory disclosure requirements that require corporations to disclose their repurchasing activity on a monthly basis in quarterly and annual statements and expressing that performing data analyses for issuer stock repurchases presents significant challenges because detailed trading data regarding repurchases is currently not available).

[273] For further information on the "disclose or abstain" rule as well as the threshold for materiality of non-public information, see SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 at 848–49 (2d Cir. 1968).

[274] Fried, *supra* note 246, at 808–10.

Exchange Act of 1934 that prevents managers from making short swing profits,[275] excludes executive stock options from the scope of the rule.[276] This exclusion enables managers to time their option exercises and sell their shares at a premium following the OMR-related corporate actions, while the absence of timely and detailed disclosure requirements on these actions causes managers to reap short swing profits without being detected by the SEC.[277]

Shareholders may also privately apply for legal remedies against insiders violating anti–manipulative provisions and the insider trading rule via OMRs.[278] However, private enforcement seems paradoxical to be brought against insiders with respect to OMRs. This paradox has been mainly due to the idiosyncratic nature of OMRs in that OMRs appear to benefit shareholders for the reasons examined above even when OMRs actually reduce aggregate shareholder value, or at least, value for less-informed shareholders.[279] Hence, it would be unnatural to expect shareholders, who react positively to OMR announcements and actual OMRs, to bring legal actions due to their losses (and also any harm done to corporations) incurred by manipulative and unlawful insider trading activities of managers via OMRs.

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[275] *See* 15 U.S.C. § 78p(b) (2018). The rule essentially prevents managers from realizing profit from any purchase and sale, or any sale and purchase, of any equity security of such issuer within any period of less than six months.

[276] *See* 17 C.F.R. § 16(b)-6 (2019). For further information, see *infra* text accompanying notes 717–18.

[277] For the origin of this claim, see Lazonick, *supra* note 40, at 53–54 (stating that, in 1991, the SEC reinterpreted the rule, which would have forced executives, who exercise stock options, to hold shares for at least six months before selling them, in a way to allow executives to hold options for at least six months and to exercise them and sell the stock immediately, and this has given executives the flexibility to time their option exercises and sell shares in order to personally benefit from price spikes caused by repurchases).

[278] In addition to the burden of proof, shareholders must also establish that they have standing as they are purchasers or sellers, they rely on fraudulent claim, and they incur losses and damages due to fraudulent claim.

[279] Fried, *supra* note 43, at 1372–74.

1.1.2 Indirect Insider Trading via Actual OMRs

Managers (as well as other non–selling shareholders) may also benefit from actual OMRs through indirect insider trading (via the corporation).[280] That is, managers, as non-selling shareholders, may reap gains via OMRs without trading in their own shares but having corporations buy their own shares especially when they are undervalued. This is because OMRs, unlike other repurchasing methods, enable corporations to repurchase their (undervalued) shares at the market price, and actual OMRs increase share prices and increase EPS.[281] Hence, repurchasing undervalued shares via actual OMRs would indirectly benefit those that choose not to trade their shares. This is because wealth would be transferred from selling shareholders, who sell their shares at a discount, to non–selling shareholders, who hold their stakes and reap gains as a result of increase in share prices and EPS through bargain repurchases.[282]

However, there might also be instances when actual OMRs transfer wealth in the opposite direction. That is, wealth might be transferred from non–selling shareholders to selling shareholders if OMRs are executed when shares are overvalued.[283] Managers may unknowingly

[280] *Id.* at 1344–47 (arguing that managers use OMRs to indirectly buy shares for themselves at a bargain price and explaining that repurchasing undervalued shares via OMRs is economically equivalent to a three-step transaction that includes non–selling shareholders buying shares at a discount from selling shareholders, non–selling shareholders receiving a dividend from the corporation equal to the amount paid to selling shareholders, and the corporation effects a reverse stock split).

[281] *See* sources cited *supra* notes 257–59 and accompanying text.

[282] Bratton, *supra* note 148, at 880–83; Fried, *supra* note 43, at 1344–47 (arguing that actual OMRs transfer value from selling shareholders to non–selling shareholders if the purchase price is less than the stock's actual value). *See also* De Cesari et al., *The Effects of Ownership and Stock Liquidity on the Timing of Repurchase Transactions,* 18 J. CORP. FIN. 1023 (2012) (finding evidence that OMRs are timed to benefit non–selling shareholders).

[283] Bratton, *supra* note 148, at 886–90 (arguing that corporations may also repurchase their overvalued shares, which would result in a transfer of value from non–selling shareholders to selling shareholders); Fried, *supra* note 43, at 1365 (arguing that OMRs may also transfer value from non–selling shareholders to selling shareholders if the stock is overpriced).

decide on repurchasing overvalued shares simply because of the miscalculation of share value due to the unforeseeable country-, market-, and industry-specific factors.[284] On the other hand, managers may also disregard the share valuation and knowingly repurchase overvalued shares to pursue private interests.[285] Accordingly, managers may have corporations repurchase overvalued shares in order to increase EPS and support market prices that would entitle them to stock options and stock awards. Indeed, the number of actual OMRs tends to increase right before quarterly and annual statements that set EPS and other targets that would trigger stock options and stock awards.[286] Consequently, if managerial gains reaped by this way exceed gains that would be reaped by bargain repurchases through indirect insider trading, managers would be able to benefit from actual OMRs without trading their own shares. In this scenario, corporations might end up buying their own shares even if shares are overvalued and repurchasing overvalued shares would result in transfer of wealth from non–selling shareholders to selling shareholders.

Although direct insider trading would be more lucrative and much simpler than indirect insider trading,[287] managers would prefer to repurchase (undervalued) shares and indirectly reap gains via

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[284] *See supra* note 217 and accompanying text.
[285] *Id.* at 876, 879 (arguing that corporations may repurchase overvalued shares and injure non–selling (and long-term) shareholders if payout decisions are driven by private interests of managers like bolstering option compensation and offsetting stock option dilution). In such cases, managers would have to make a cost-benefit calculation before deciding on repurchasing overvalued shares as they would also incur losses due to repurchasing of overvalued shares, unless they sell all their shares and exit. *See also* Fried, *supra* note 41.
[286] *Compare* Hector Almeida et al., *The Real Effects of Share Repurchases*, 119 J. FIN. ECON. 168 (2016) (finding that corporations that narrowly miss EPS forecasts are significantly more likely to execute OMRs than corporations that beat their EPS forecasts), *and* Paul Hribar et al., *Stock Repurchases as an Earnings Management Device*, 41 J. ACCT. & ECON. 3 (2006) (finding a disproportionately large number of accretive repurchases among firms that would have missed analyst EPS forecasts without the repurchase) *with* Yingmei Cheng et al., *Bonus-Driven Repurchases*, 50 J. FIN. & QUANTITATIVE ANALYSIS 447 (2015) (finding that when a CEO's bonus is directly tied to EPS, his company is more likely to conduct a buyback).
[287] Fried, *supra* note 41, at 869–71, 884–85 (putting forward the managerial-opportunism theory as an alternative to signalling theory in explaining OMRs and arguing that the signaling theory is theoretically problematic because it assumes that managers deliberately sacrifice their own wealth to increase that of shareholders, whereas the managerial-

actual OMRs due to various reasons. First, managers would engage in direct insider trading and buy shares, if undervalued, on their own accounts until they face liquidity constraints. Managers would then continue to engage in indirect insider trading via actual OMRs, which are financed by corporate cash, until the corporation lacks sufficient cash to finance OMRs.[288] Second, Section 16(b) of the Securities Exchange Act of 1934, which prohibits managers from reaping short swing profits by way of purchase and sale (or sale and purchase) within six months, do not apply to indirect insider trading.[289] Third, corporations may adopt policies to restrict managers to trade in their own shares via blackout periods, in which corporations would be able to continue to repurchase their own undervalued shares that would indirectly benefit managers.[290]

Finally yet importantly, insider trading laws, though not easily enforceable, might make insiders hesitant to commit insider trading especially when insiders know that they possess information that is clearly material.[291] On the other hand, managers engaging in insider trading are required to disclose their trades within two days, whereas a similar trade-disclosure rule is absent in terms of indirect insider trading as corporations are required to disclose their trades on a monthly basis only in quarterly and annual statements.[292] For all these reasons, monitoring and detecting indirect insider trading around OMR activity of corporations has been much more difficult than direct insider trades.

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opportunism theory starts from an arguably more realistic assumption that managers, as rational and self-interested investors, are expected to purchase undervalued shares with their own wealth instead of repurchasing them with corporate cash and later use OMRs to maximize their own wealth even if they come at the expense of public shareholders).

[288] *Id.* at 884. *See also* Raad & Wu, *supra* note 254, at 57 (arguing that managers directly buy as many shares as they would like on the market until they face liquidity constraints).

[289] Fried, *supra* note 41, at 884–85.

[290] *Id.* at 885.

[291] Fried, *supra* note 43, at 1347.

[292] Fried, *supra* note 246, at 814–15.

1.2 Active Institutional Shareholders' Ability to Exploit OMRs

One of the two main features of most US corporations has been ownership dispersion. Dispersed ownership has been the main cause of the other main feature of these corporations, namely the separation of ownership and control.[293] The separation of ownership and control is understood as shareholders as owners of corporations ceding authority to managers to exercise control. The relationship between shareholders and managers is widely claimed to fit the definition of agency relationship, in which shareholders are principals that hire managers as their agents.[294] Parties to such relationship are likely to have divergent interests that would incur agency costs, which include monitoring costs borne by shareholders in order to monitor managers.[295] However, ownership dispersion impedes retail shareholders from effectively monitoring managers due to the rational apathy arising out of insignificant benefits and high costs of active monitoring.[296]

One way to reduce such apathy would be to diminish dispersed ownership by way of larger shareholders holding larger stakes in corporations. Indeed, the formation of institutional shareholders, who are expected to more effectively monitor managers, were encouraged by the investor recognition of the value of low-cost diversification as well as the favourable regulatory and tax treatment of institutional shareholders by the government.[297] However, institutional

[293] BERLE & MEANS, *supra* note 82.
[294] Jensen & Meckling, *supra* note 129, at 309.
[295] *Id.* at 308 (defining agency costs as the sum of monitoring expenditures and residual loss borne by principals as well as bonding expenditures borne by agents).
[296] BERLE & MEANS, *supra* note 82 (claiming that the normal apathy inherent in shareholders with smaller stakes would cause them to not effectively exercise their voting rights); STOUT, *supra* note 134, at 70.
[297] Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP., Summer 2017, at 89, 91.

shareholders, particularly pension and mutual funds, also remained largely passive throughout the second half of the twentieth century. Thus, they failed to meet the expectation to effectively monitor management. This is because institutional shareholders, although to a lesser extent than retail shareholders, also suffer from the rational apathy due to their diversified portfolios.[298]

In order to address shareholder passivity, institutional shareholders have been required to vote shares they hold in portfolio corporations under the fiduciary duty towards their investors since the 1990s.[299] Similarly, in 2003, the SEC required management investment companies and registered investment advisers to adopt and disclose policies and procedures reasonably designed to ensure that they vote proxies in the best interests of clients.[300] In order to minimize costs associated with these requirements, institutional shareholders have outsourced their voting decisions to proxy advisory firms that emerged to help institutional shareholders to monitor corporations in their portfolios and cast votes accordingly.[301] Consequently, institutional shareholders have become more active and more informed than retail shareholders.

Meanwhile, the number of more active forms of institutional shareholders, namely hedge funds, dramatically increased in the 1990s.[302] Hedge funds, unlike other institutional investors that are offered publicly, are offered privately to wealthy individuals and corporations, namely accredited

[298] STOUT, *supra* note 134, at 93–94. Diversified portfolios cause institutional shareholders to encounter collective action and free-riding problems exacerbated by conflicts of interests between shareholders, while institutional shareholders also face legal obstacles and obstacles posed by managers.
[299] John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 557 (2015).
[300] *Id.*
[301] *Id.* at 558.
[302] For further information on the rise of hedge funds in the 1990s, see Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 79–80 (2011).

investors.[303] Accredited investors are sophisticated market participants, who have high-risk high-return investment expectations. The investment expectations of their investors compel hedge fund managers to more actively engage in business decisions of corporations. Consequently, hedge funds have become more active in the management of corporations that they hold concentrated blocks of shares. Such active ownership largely eliminates the apathy associated with institutional shareholders having diversified portfolios.[304] In addition to their expertise and sophistication, hedge funds can also engage the services of proxy advisory firms. Moreover, hedge funds typically nominate director(s). Once a fund-nominated director is appointed by the corporation, information leakage and thereby informed (options) trading abruptly increases.[305] These factors enable hedge funds to have access to more information than other active institutional shareholders. As a result, active institutional shareholders, led by hedge funds, would have information superior to that of other shareholders.[306]

Active institutional shareholders may use their informational advantage to exploit OMRs at the expense of less-informed shareholders. This is because more informed shareholders are likely to have a better estimate on the market price and the potential impact of OMRs on share prices than less-informed shareholders. Moreover, OMRs distribute cash to shareholders disproportionately, unlike dividends, so that they aggravate adverse selection. Adverse selection enables more informed shareholders to adjust their trades to directly or indirectly reap gains via OMRs at the

[303] For a more detailed definition of the term accreditor investor, *see* 17 C.F.R. § 230.501(a) (2019).
[304] Coffee & Palia, *supra* note 299, at 548, 553.
[305] John C. Coffee Jr., et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board*, 104 CORNELL L. REV. 381 (2019).
[306] Brennan & Thakor, *supra* note 41, at 995 (arguing that large shareholders would have a greater incentive to become informed than small shareholders on the assumption that there is a fixed cost of collecting information).

expense of less-informed shareholders that would be on the other side of the trade.[307] In theory, active institutional shareholders would be expected to favour cash distributions to shareholders in any form in order to constrain managers, mitigate agency costs, and increase share value. However, they seem actually to prefer that corporations distribute cash via OMRs rather than dividends when it comes to choose between these two payout methods.[308] Consequently, active institutional shareholders, who have access to superior information, are able to exploit OMRs at the expense of less-informed shareholders.

In response to active institutional shareholders' ability to exploit OMRs, legal limitations on insider trading remain inapplicable to a very large extent. Many active institutional shareholders, including hedge funds that typically hold larger blocks than other institutional investors,[309] hold

[307] *Id.* (reiterating that share repurchases, unlike dividends, do not distribute cash to shareholders on a pro rata basis, and that this nonproportional aspect of repurchases renders less-informed (smaller) shareholders vulnerable to expropriation by the better informed (larger) shareholders since the former will be left with either a larger share of the company when the repurchase price is too high or a smaller share of the company when the repurchase price is too low); Ricky W. Scott, *Institutional Investors, Stock Repurchases and Information Asymmetry*, 5 INT'L J. FIN. RES., Oct. 2014, at 39 (finding that increased institutional ownership leads to increased stock repurchases and this relationship is stronger in firms with higher information asymmetry and stating that their results indicate that institutional investors encourage management to increase repurchases so as to exploit their informational advantage over less-informed investors about the true value of the firm); William Lazonick, *The Curse of Stock Buybacks*, THE AM. PROSPECT, Summer 2018, at 1, 5 (arguing that hedge fund managers can access the information on the timing of execution of OMRs and time their sales to take advantage of OMR activity).

[308] For the positive correlation between the number of OMRs and the ownership percentages of institutional shareholders mainly based on the catering effect, see Bartov et al., *supra* note 216 (showing the domination of a corporation's stockholder base by institutional investors as another cause of the likelihood of corporations to distribute cash to investors through open-market repurchases than through dividend increases); DeAngelo et al., *supra* note 178, at 352 (arguing that the increased importance of institutional ownership may play a complementary role as institutional investors would pressure managers to keep stock values high, and such pressures could explain the popularity of repurchases over dividends); Scott, *supra* note 307. Institutional shareholders would not only pressure managers to repurchase shares but also prefer to invest in corporations that already repurchase shares. For evidence on this clientele effect, see Yaniv Grinstein & Roni Michaely, *Institutional Holdings and Payout Policy*, 60 J. FIN. 1389 (2005).

[309] STOUT, *supra* note 134, at 93–94; Coffee & Palia, *supra* note 299, at 548, 553.

stakes that are not larger than 10%.[310] Therefore, most institutional shareholders fall out of the scope of Section 16 of the Securities Exchange Act of 1934 and implementing rules that include shareholders holding more than 10% of outstanding shares.[311] Most institutional shareholders hold stakes of less than 10% mainly because it is difficult for any shareholder to hold stakes of more than 10% in large corporations with dispersed ownership structure. Additionally, active institutional shareholders tend to deliberately hold less than 10% of outstanding shares in order to stay out of the scope of the rule, which requires insiders to report equity ownership and restricts their ability to reap short swing profits.[312] Moreover, the combination of the amendments to the proxy rule by the SEC[313] and the shareholder strategies such as the wolf pack tactic[314] allows active institutional shareholders to communicate with each other and act in parallel without legally forming a group. By doing so, they altogether have more than 10% of the outstanding shares of corporations in the aggregate with none of them individually exceeding the 10% threshold. As a result, active institutional shareholders having informational advantage remain legally unconstrained, although they are able to extract material economic benefits via OMRs at the expense of less-informed shareholders due to the inflationary and disproportionate nature of OMRs.

2. OMR-Induced Underinvestment

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[310] Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 682, 697 n.107, 705–06 & n.170 (2007).
[311] 15 U.S.C. § 78p(a) (2018).
[312] *Id.*
[313] Coffee & Palia, *supra* note 299, at 559–61.
[314] *Id.* at 562–68.

The ability of both managers and active institutional shareholders to exploit OMRs potentially causes their interests to align with respect to OMRs. Meanwhile, the interests of managers and certain active institutional shareholders have become increasingly financial and shorter. First, managers, whose compensation is largely tied to share price and EPS performance via quarterly earnings reports, tend to bolster their compensation by increasing share prices and EPS via OMRs in the short-term.[315] Second, certain active institutional shareholders engage in activism that would lead them to have short-term investment horizons. These short-term shareholder activists interfere in corporate governance and business decisions of corporations and pressure managers to pursue short-term policies including OMRs that would inflate share prices and meet their short-term financial interests.[316]

The alignment of interests of managers with those of short-term shareholder activists on OMRs could cause corporations to excessively execute OMRs. The excessive use of OMRs would result in the distortion of payout policies, particularly the amount of payout, and might cause underinvestment.[317] OMR-induced underinvestment would ultimately harm corporations and

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[315] Lazonick, *supra* note 40, at 48 (arguing that the main reason for managers to devote massive resources to OMRs has been that stock-based instruments make up the majority of their pay, and OMRs drive up stock prices and EPS in the short term and enable them to hit quarterly share price and EPS targets that entitle them to stock-based instruments).
[316] *Id.* at 9 (arguing that hedge fund activists have purchased large amounts of shares from certain corporations and then pressured their management to announce large OMR programs). *See also* Lazonick, *supra* note 307, at 2 (arguing that hedge fund activists have increasingly pressured corporations to do buybacks since the mid–2000s); Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1279 (2007) (arguing that activist hedge funds take large positions in as few as two or three companies and then demand those companies to launch massive stock buyback programs); Coffee & Palia, *supra* note 299, at 573 (voicing a concern that hedge fund activism may lead to short-termism and arguing that these shareholders usually favor a managerial strategy that seeks to increase shareholder distributions by way of dividends and/or stock buybacks).
[317] Fried, *supra* note 43, at 1367–69 (arguing that the possibility of immediate profits from informed repurchasing can cause managers to squander cash that should be invested in the firm's own projects); Lazonick, *supra* note 40, at 48–49 (identifying the problem as the distribution of retained earnings to shareholders particularly via OMRs instead of investments in productive capabilities).

thereby all corporate stakeholders having long-term interests including long-term shareholders as well as employees, households (in their capacities as both taxpayers and consumers), and creditors.

Hence, this section consists of two subsections: the first of which explains how interests of managers and short-term shareholder activists with respect to OMRs are aligned—the alignment that is likely to cause corporations to excessively execute OMRs. The second subsection discusses whether and why aligned interests would cause corporations to excessively execute OMRs and examines whether and how the excessive number of OMRs would cause underinvestment and harm corporations and corporate stakeholders having long-term interests through harming corporations.

2.1 The Alignment of Interests of Managers and Short-Term Shareholder Activists

Notwithstanding both managers and active institutional shareholders are able to exploit OMRs, they may dissent on how much (and when) cash should be distributed to shareholders and how much of these distributions should be in the form of OMRs. Managers, who have the sole authority to execute OMRs, historically tend to reinvest cash into investment projects. Shareholders, particularly active institutional shareholders, would prefer managers to distribute cash to themselves, and particularly through OMRs since OMRs would increase share value and satisfy their financial interests at the same time.[318] In the face of this conflict of interests of managers and shareholders, shareholder value theory assumes that corporate interests are best aligned with those of shareholders. The theory thus suggests that managers must aim for maximizing shareholder

[318] *See supra* notes 130–31 and accompanying text.

value, and shareholders must monitor managers as to whether managers pursue policies that satisfy shareholders' interests.[319]

Recalling that this relationship between shareholders and managers is regarded as agency relationship, costs associated with the conflict of interests of parties to this relationship have been described as agency costs.[320] Agency costs include monitoring costs that are borne by shareholders. Monitoring costs include not only the cost of information acquisition necessary for monitoring but also costs of incentive mechanisms for managers to maximize shareholder value.[321] These mechanisms are led by stock-based compensation that ties executive compensation to share price and EPS targets. Hence, managers would automatically enhance shareholder value while working to increase share prices and EPS to reach the targets and reap personal gains.

Moreover, managers must reach these targets in the short-term, since these targets are typically set by quarterly financial reports. In this context, OMRs appear as financial tools that have the effect of inflating share prices and EPS in the short-term and enable managers to hit quarterly share price and EPS targets.[322] Indeed, evidence suggests that managers are likely to execute OMRs when they have bonuses that are directly tied to EPS,[323] and especially when they would have just missed EPS targets in the absence of OMRs, which would have ultimately deprived themselves of their

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[319] Milton Friedman, *A Friedman Doctrine - The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, *available at* http://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.
[320] Jensen & Meckling, *supra* note 129, at 308–10.
[321] *Id.*
[322] Lazonick, *supra* note 40, at 48.
[323] Cheng et al., *supra* note 286 (finding that when a CEO's bonus is directly tied to EPS, the company is more likely to conduct a buyback).

stock awards.[324] Consequently, the combination of OMRs with stock-based executive compensation contingent upon quantitative metrics in quarterly earnings reports that could be inflated by OMRs enables managers to execute OMRs for their own financial interests in the short-term.

This is not to say that all managers would always prioritize their own financial interests that might cause them to distribute too much cash to shareholders via OMRs. However, active institutional shareholders prefer corporations to distribute cash to shareholders. Above all, certain active institutional shareholders, particularly hedge funds, may engage in activism and pressure managers into shareholder-oriented policies including payout decisions led by OMRs.[325] These shareholders are able to engage in such activism owing to (i) larger blocks of shares they hold and higher level of information they have,[326] (ii) the deregulation of rules and regulations for the purpose of increasing active monitoring,[327] and (iii) the adoption of certain governance policies and practices pushed by proxy advisory firms.[328] Increased activism has also been argued to lead to short-

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[324] *Id.* (finding that repurchases are EPS-driven especially when a company's EPS is right below the threshold for a bonus award). *See also* Almeida et al., *supra* note 286 (finding that the probability of share repurchases is sharply higher for corporations that would have just missed the EPS forecast in the absence of the repurchase); Hribar et al., *supra* note 286.

[325] Lazonick, *supra* note 307, at 2 (arguing that hedge fund activists have increasingly pressured corporations to do buybacks by using a corrupt proxy-voting system and wolf pack hook-ups with other hedge funds). *See also* sources cited *supra* note 316 and accompanying text.

[326] *See supra* Part D.1.2.

[327] Coffee & Palia, *supra* note 299, at 559–62 (regarding the changes in rules and regulations as one of the factors contributing to the increase in activism and enumerating changes made by the SEC, including but not limited to the permission to proxy advisors to distribute proxy voting advice to shareholders and the permission to statements amounting to proxy solicitation, the authorization of short-slates, the permission to unlimited communication with other shareholders before the filing of proxy statement, and the elimination of the requirement to mail proxy statement as well as the elimination of the discretionary broker voting and the requirement to corporations to hold shareholder advisory votes on executive compensation under the Dodd-Frank Act).

[328] *Id.* at 557–59, 562, 570–72 (enumerating corporate practices that corporations widely adopt at the request of proxy advisory firms, including but not limited to proxy access, non–staggered boards, and majority voting standard, and describing how each of these corporate practices enable activist shareholders to pressure boards to increase the payout

termism in that investment horizons of activist shareholders have been shortened.[329] Thus, short-term shareholder activists would prefer corporations to distribute cash to shareholders particularly through share repurchases due their inflationary effect on share prices and EPS in the short-term.[330] As a result, short-term shareholder activists would actively pressure managers to make decisions to promote short-term share price increases and to distribute cash to shareholders. Both of these objectives could be accomplished via share repurchases led by OMRs.

In response to these pressures, some managers, who do not want to pursue short-term policies including OMRs, may choose to resist and force dissenting shareholders to exit the corporation.[331] Such dissent traditionally causes shareholders to exit by selling their shares. However, short-term shareholder activists, by their nature, may choose to interfere with management before considering exit.[332] Such interference by short-term shareholder activists, who have recently been increasing in number and are acting empowered,[333] would cause managers to face the threat of being replaced

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to shareholders led by share repurchases). For an overview on the influence of proxy advisory firms and a criticism on their unconstrained power, see Tamara Belinfanti, *Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, 14 STAN. J. L., BUS. & FIN. 384 (2008).

[329] Coffee & Palia, *supra* note 299, at 573 (stating that hedge funds might be more short-term oriented due to compensation structure of hedge fund managers that prescribe generous fees as well as hedge fund investors' expectations for quick returns that outperform the market, and the intense competition among hedge funds).

[330] José-Miguel Gaspar et al., *Payout Policy Choices and Shareholder Investment Horizons*, 17 REV. FIN. 261 (2013) (finding that the frequency and amount of repurchases (and repurchase announcements) increases with ownership by short-term investors to the detriment of dividends so that shorter shareholder investment horizons might be one contributing factor to the increasing popularity of buybacks that increase prices in the short-term).

[331] This option may also be associated with OMRs. *See* Sheng Huang & Anjan V. Thakor, *Investor Heterogeneity, Investor-Management Disagreement and Share Repurchases*, 26 REV. FIN. STUD. 2453 (2013) (arguing that dissenting shareholders may want to sell their shares and exit corporations and managers may use OMRs (as well as privately negotiated repurchases) to buy out shareholders, who are more likely to disagree with management, that would facilitate alignment between managers and shareholders by concentrating ownership in the hands of management as well as shareholders that are more likely to agree with management).

[332] Coffee & Palia, *supra* note 299, at 553.

[333] *See supra* notes 326–28 and accompanying text. For an extensive summary of arguments in favour of increasing shareholder power, see Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

or taking a pay cut.[334] Therefore, managers are likely to lean towards shareholder proposals, particularly those on OMRs, since they are also able to reap personal gains via OMRs.[335] As a result, interests of managers align with those of short-term shareholder activists with respect to OMRs.

2.2 Adverse Consequences of Excessive Use of OMRs due to Aligned Interests

The alignment of interests of managers and short-term shareholder activists with respect to OMRs might result in corporations to pay out too much cash to shareholders through the execution of excessive number of OMRs. Shareholder payout figures indicate that almost all of the net incomes of large US corporations are spent on shareholder payouts, the vast majority of which have been in the form of OMRs. For instance, S&P 500 shareholder payout figures show that from 2003 to 2012 S&P 500 firms spent 91% of their aggregate net income (a total of $2.4 trillion) for shareholder

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[334] Anabtawi & Stout, *supra* note 316, at 1298 (giving an example that a shareholder may be able to determine a board's decision with regard to a particular matter—say, a share repurchase program—by threatening a proxy battle, or by undertaking an aggressive public relations campaign directed at the board); Marcel Kahan & Edward B. Rock, *Embattled CEOs,* 88 TEX. L. REV. 987, 1050 (2010) (arguing that hedge funds empower managers by securing their positions and expanding their options and opportunities, whereas they weaken managers by increasing the likelihood of a change of control by closely monitoring their investments in public companies, and by tightly controlling portfolio companies by way of setting and monitoring goals and firing underperforming managers).

[335] Bratton & Wachter, *supra* note 217, at 686 (arguing that managers became more attuned to the shareholder agenda with respect to OMRs); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?,* 66 BUS. LAW. 1, 15 (2010) (arguing that corporations engaged in huge stock buyback programs in response to investor sentiment); Martin Lipton, *Some Thoughts for Boards of Directors in 2016*, HARV. L. SCH. F. CORP. GOVERNANCE & FIN. REG. (Dec. 9, 2015), http://corpgov.law.harvard.edu/2015/12/09/some-thoughts-for-boards-of-directors-in-2016 (arguing that boards and management teams follow the advice to think like an activist so that corporations have been fundamentally altering their business strategies in favour of stock buybacks in response to short-term pressures brought by short-term shareholders led by hedge funds); OECD, BUSINESS AND FINANCE OUTLOOK 2015, (2015), *available at* http://www.oecd.org/finance/oecd-business-and-finance-outlook-2015-9789264234291-en.htm (corporations appear to be adjusting to the demands of investors for greater yield via dividends and buybacks).

payouts, with buybacks (54% of net income) being the biggest expense item.[336] Paying out too much cash to shareholders, particularly via OMRs, would come at the expense of long-term interests of corporations. This is particularly the case when retained earnings that need to be spent on value-creating investment projects, research and development and capital expenditures for corporations to sustain their operations in a competitive marketplace are distributed to shareholders.

Short-term shareholder activists may disregard the long-term consequences of OMR-induced underinvestment on corporations because they typically depart from corporations before consequences of short-term policies ensue.[337] Even if short-term shareholder activists have to bear consequences of short-term policies prior to their departure, they would not be affected as much

[336] *See, e.g.*, Lazonick, *supra* note 40, at 48 (reporting that 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012 used 54% of their earnings to buy back their own stock, almost all through OMRs, and 37% of their earnings to pay dividends during that period). For arguments against the relevance of S&P 500 shareholder payout figures, see Jesse M. Fried & Charles C. Y. Wang, *Short-Termism and Capital Flows*, 8 REV. CORP. FIN. STUD. 207 (2019) (criticizing that these figures predicate on total payouts instead of net payouts as they exclude direct and indirect equity and debt issuances that partly offset total payouts, and that these figures are misleading since S&P 500 firms have fewer growth opportunities and are net exporters of equity capital, whereas smaller and younger public firms outside of the S&P 500 have more growth opportunities and are net importers so that the aggregate net shareholder payouts of all public firms would be lower. They also argue that corporations sufficiently allocate about 25–30% of net income to R&D and capital expenditures prior to distributions to shareholders, and corporations are able to raise capital through additional equity and debt issuances if they have promising investment opportunities, and cash distributions to shareholders find their way to private firms). For responses to these claims, see William Lazonick, *Innovative Enterprise Solves the Agency Problem: The Theory of the Firm, Financial Flows, and Economic Performance* (Inst. for New Econ. Thinking, Working Paper No. 62, Aug. 28, 2017), *available at* http://ssrn.com/abstract=3081556 (arguing that the presence of equity and debt issuances do not indicate how these funds are used, and the uses of funds do not indicate whether they translate into innovation and higher wages, and claiming that these figures have still been a relevant indicator since firm-specific analysis indicates that R&D spending has been concentrated in a handful of S&P 500 firms in that 289 companies of S&P 500 firms recorded zero R&D expenses, whereas 55 corporations did the 84 percent of total R&D spending, and even if corporations would have done sufficient R&D expenditures, such investment would not necessarily result in innovation and higher wages because corporations need financial commitment in the form of retained earnings that have been one of the conditions for corporations to sustain by continuously financing collective learning that is necessary for innovation, the process of which is uncertain, to cumulate over time).

[337] Strine, *supra* note 335, at 8 (arguing that activist shareholders are able to make proposals and vote on business decisions motivated by interests other than maximizing the long-term, sustainable profitability of the corporation, and can easily depart and not eat their own cooking).

as other corporate constituents. Yet, their relatively diversified portfolios and a wide variety of trading strategies such as the use of equity derivatives and other financial contracts would allow them to hedge against the economic consequences of a decline in the corporation's share price.[338] On the other hand, the alignment of interests of managers with those of short-term shareholder activists with respect to OMRs may also entice managers to excessively execute OMRs by disregarding the potential consequences of OMR-induced underinvestment on corporations in the long-term.[339] Moreover, in case of any harm done to corporations that would cause corporations to fail, managers, whose tenure has been shortened, may walk away with hefty compensation packages. Such managers may even find jobs in open managerial labor markets with their generalist knowledge and reputation as shareholder value maximizers.

The possibility that excessive use of OMRs, which have a number of benefits from a shareholder point of view, would cause underinvestment and harm corporations refutes the main assumption of shareholder value theory that the interests of corporations are best aligned with those of their shareholders. The refutation of the main assumption calls into question the underlying assumption that shareholders have a common interest. Shareholders of corporations, which are characterized

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[338] Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L. REV. 562, 583–86, 590–93 (2006).

[339] For short-term shareholder activists' influence on managers' buyback decisions that come at the expense of long-term interests of corporations, see Lipton, *supra* note 335 (arguing that, in response to short-termist pressures brought by hedge funds and activist shareholders, corporations have been fundamentally altering their business strategies to forego long-term investments in favor of stock buybacks as well as dividends and other near-term capital returns); OECD, BUSINESS AND FINANCE OUTLOOK 2015, (2015), *available at* http://www.oecd.org/finance/oecd-business-and-finance-outlook-2015-9789264234291-en.htm (reporting that investor demand induces US corporations to devote their earnings to buybacks instead of investment). *See also* Almeida et al., *supra* note 286 (finding that corporations are highly likely to cut investments to repurchase shares to avoid a near-miss of an EPS forecast, which suggests that managers are willing to trade off investments and employment for stock repurchases that allow them to meet analyst EPS forecasts). This is because managers have private interests with respect to OMRs that cause managers to disregard the long-term consequences of OMRs on corporations. For these private interests, see generally Part C.2.

by dispersed ownership, have peculiar characteristics that lead them to have private interests that diverge from, and may even come at the expense of, the common interest of all shareholders.[340] Such divergence of interests would also arise in the case of OMRs. OMRs increase share prices and market liquidity and enable shareholders having short-term financial interests to tender shares at favourable prices. These trades may harm long-term shareholders, who would not typically tender their shares and get paid within an OMR program. Rather, long-term shareholders would expect to receive dividends as a result of value creating investment strategies of corporations in the long-term. Thus, corporations excessively executing OMRs seem to prioritize the interests of short-term shareholders over those of long-term shareholders. In this sense, OMRs have been financial tools that are unable to create value but rather help certain interest groups to extract value.

On the other hand, there have been a number of studies that find that repurchase announcements (and subsequent actual repurchases) are associated with positive abnormal long-term returns.[341] Most of these studies consider the period of 12 months up to 48 months following a repurchase announcement as long-term.[342] However, OMR announcements typically do not set a time frame and data suggests that it takes around 20 months for around three-fifths of US corporations to complete their announced repurchase targets.[343] Hence, considering that the vast majority of repurchases has been in the form of OMRs, findings of these studies have been far from being

[340] Anabtawi, *supra* note 338, at 575–77 (arguing that shareholders have private interests that diverge from the common interest of shareholders and such private interests may induce influential shareholders to engage in rent-seeking activities at the expense of aggregate shareholder value). *See also* STOUT, *supra* note 134, at 69.
[341] For the worldwide collection of statistical evidence on the effect of OMRs on long-term shareholder value, 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 (2019) (stating that, both in and outside the US, share repurchases are associated with significant positive short- and long-term excess returns).
[342] *Id.*
[343] Simkovic, *supra* note 126, *passim*.

meaningful. More importantly, these studies suggest that the number of repurchase announcements and subsequent excess returns increase with the likelihood of undervaluation.[344] That is to say, the relationship between positive long-term abnormal returns and OMRs is not causation but rather correlation; and the positive correlation between positive long-term abnormal returns and undervaluation indicates that the long-term abnormal returns are likely to be positive due to the regression to the mean.[345] Thus, positive abnormal returns following repurchase announcements fail to suggest that OMRs necessarily benefit shareholders in the aggregate,[346] and long-term shareholders in particular.

Actual OMRs, too, could be claimed to be beneficial for long-term shareholders based on the assumption that shares to be repurchased are undervalued.[347] Indeed, long-term shareholders would typically choose not to sell their shares within an OMR program and benefit from bargain repurchases. However, they may occasionally want to get paid in dividends and sell a portion of their shares in an OMR program without knowing the fact that shares are undervalued. On the other hand, short-term shareholders, who are typically activists that have access to information superior to that available to long-term shareholders, would know of the undervaluation and choose

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[344] Manconi et al., *supra* note 341.

[345] Bhattacharya & Jacobsen, *supra* note 162; Manconi et al., *supra* note 341 (finding that the level of excess returns is positively correlated with the likelihood of undervaluation). This is because short-term shareholder activists usually target underperforming corporations and/or corporations having excess cash, which is consistent with the tendency of managers to retain excess cash for the purpose of timing OMRs when shares are undervalued. For a similar argument, see Fried, *supra* note 43, at 1373 (arguing that managers tend to retain cash to time actual OMRs when shares are undervalued and retaining cash that should be distributed immediately to shareholders would incur costs and negatively affects share prices before the announcement of a repurchase program so that the market reaction to the announcement would be much stronger).

[346] Fried, *supra* note 43, at 1372–74 (arguing that one cannot infer from the price-boosting effect of repurchase announcements that the announced repurchases increase value).

[347] Bratton, *supra* note 148, at 886 (arguing that the beneficiaries of bargain repurchases (repurchases executed when prices are undervalued) are non–selling shareholders, namely the long-term investors).

not to sell within an OMR program. In such scenario, short-term shareholder activists would exploit OMRs at the expense of less-informed shareholders by adjusting their trades around actual OMRs owing to their informational advantage.[348] Furthermore, repurchasing overvalued shares would definitely harm long-term shareholders.[349]

The alignment of interests of managers and short-term shareholder activists would not only distort the payout amount but also the payout method. Once a corporation decides to distribute cash to shareholders, the ability of managers and short-term shareholder activists to derive private benefits via OMRs may induce managers to prefer OMRs even in cases when alternative mechanisms, in particular regular and special dividends, would be more efficient than the use of OMRs in achieving their intended purpose.[350] Consequently, the alignment of managers and short-term shareholder activists with respect to OMRs would harm the rest of the shareholders by distorting the payout method as well.

OMRs could be exploited to the detriment of certain shareholders even though the agency theory gives primacy to shareholders. Shareholder primacy is justified by agency theory that identifies shareholders as the only group of stakeholders, whose claims are residual.[351] Residual claimant status has been ascribed to shareholders because their contributions are not contractually guaranteed and that they have claims only on net cash flows. That is to say, shareholders may have

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[348] *See supra* note 307 and accompanying text.

[349] Bratton, *supra* note 148, at 887–89 (arguing that repurchasing overvalued shares are dilutive in that the value of the non–selling (typically long-term) shareholder's increased proportionate ownership would be less than the pro rata cost of the outflow to the selling (typically short-term) shareholders).

[350] Fried, *supra* note 43, at 1369–70.

[351] *See generally* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J. L. & ECON. 327 (1983).

a claim on corporate cash flow only after the deduction of all other stakeholder claims that have been contractually guaranteed. Shareholders would be able to generate profits when corporations declare dividends and/or carries out other forms of payout. Accordingly, shareholders might be described as residual claimants only when a corporation they invest in goes bankrupt and liquidates. Even in cases of bankruptcy and liquidation, personal assets of shareholders are protected by the notion of limited liability. Hence, losses of shareholders would be limited to any decline in value of shares that could easily be sold in liquid markets. These losses could also be mitigated owing to relatively diversified portfolios shareholders might have and a variety of trading strategies available to them.

However, in case of corporate failures, other stakeholders also incur losses. For example, employees, who make investment in firm-specific human capital, would face the risk of becoming unemployed when the corporation goes bankrupt. However, agency theory ignores the risk-bearing status of employees and does not regard employees as residual claimants. This implication is based on the premise that employees receive contractually guaranteed returns in the form of salary and are seen as an interchangeable commodity whose services can be hired and fired as needed on the labor market. This particular view undermines job stability, and unstable employment can inhibit corporations from integrating employees into the collective and cumulative learning processes that are the essence of innovation.[352] In this context, spending too much cash on OMRs, which have been beneficial tools from the agency theory perspective, would essentially come at the expense

[352] Lazonick, *supra* note 336, at 5.

of successful investments in innovation and productive capabilities and force corporations to downsize-and-distribute, the consequences of which are borne by employees.[353]

Households also bear risks as taxpayers. Taxpayers make investments in productive capabilities of corporations through government agencies; namely, investments in physical infrastructure and human knowledge that corporations need in order to generate competitive products.[354] Taxpayers receive returns on their investments in two main ways. First, governments, representing taxpayers, tax corporations for their profits from innovation.[355] Second, taxpayers, in their capacity as consumers, expect to gain from the innovative capabilities of corporations through the production of higher-quality, lower-cost products.[356] Thus, returns to taxpayers depend on the success of the innovation process as well as the tax policy of the government, and are by no means guaranteed.[357] If corporations fail to efficiently allocate resources and sacrifice investments on innovation for the sake of short-term gains through strategies like OMRs, taxpayers would miss out returns generated by innovation. Moreover, taxpayers may have to bail out, through government agencies, failing

[353] *Id.* at 28–30 (stating that the General Motors reduced labor costs by $11 billion via layoffs, wage cuts, and reduced benefits, whereas General Motors did $20.4 billion worth of buybacks from 1986 through 2002 and considered buying back another $5 billion in stock in order to settle a fight with activist shareholders). *See also* William Lazonick, *How Stock Buybacks Make Americans Vulnerable to Globalization* 9 (The Academic-Industry Res. Network, Working Paper No. #16-0301, Mar. 1, 2016), *available at* http://ssrn.com/abstract=2745387 (stating that high-tech companies such as IBM, HP, Intel, Microsoft, and Cisco lay off thousands of experienced employees while doing billions of dollars in buybacks).
[354] Lazonick, *supra* note 336, at 42.
[355] *Id.* at 42.
[356] *Id.*
[357] *Id.* at 40. For a concrete and recent example on the effect of tax policy of governments, see Lazonick, *supra* note 307 (claiming that additional after-tax profits provided by the tax cut will be used to enrich shareholders through stock buybacks and cash dividends instead of making productive investments).

corporations that execute OMRs at record levels prior to the advent of adverse market conditions that would bring corporations to the brink of bankruptcy.[358]

OMRs might adversely affect corporate creditors as well.[359] OMRs enable shareholders to behave opportunistically at the expense of corporate creditors in various ways. First, shareholders favor cash distributions, particularly via OMRs, that would have the effect of reducing corporate capital, on which creditors rely at the contract date.[360] Second, OMRs, if financed by debt, cause corporations to take on additional debt that would dilute creditors' claims on corporate assets once the corporation becomes insolvent.[361] Third, shareholders favor cash distributions via OMRs that may cause management to forego positive NPV investment projects, the beneficiary of which would be creditors.[362]

In fact, shareholders should refrain from behaving opportunistically at the expense of creditors. Yet, such opportunistic behaviour would eventually harm shareholders through harming

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[358] Lazonick, *supra* note 336, at 25–30 (arguing that Wall Street banks did buybacks to manipulate their share prices, and then had to turn to US taxpayers, who absorbed massive share issues to bail them out instead of using cash that was spent on OMRs to avert financial crisis, and also arguing that buybacks also played a role in General Motors (as well as General Electric) to get into financial distress to the point that taxpayers found themselves in the position of having to keep the company from liquidating).
[359] While OMRs could be exploited to the detriment of both voluntary and involuntary creditors, this section focusses on voluntary creditors and uses the term creditor as if it includes voluntary creditors like debtholders. Yet, it would be even more difficult for involuntary creditors, such as tort victims, to protect themselves where senior creditors, who are better able to protect themselves via contract, fail to protect themselves.
[360] Enriques & Macey, *supra* note 27, at 1168–69.
[361] *Id.* at 1169. It should also be noted that corporations ought to be cautious to not excessively take on debt, since the inflexibility of debt obligations may cause the risk of bankruptcy in times of market crisis, and such risk is more prevalent for US corporations because their innovation process is radical rather than incremental and thereby investments in productive capabilities have been riskier as there is no guaranteed return on investments. In a system where there is no guaranteed return on investments, taking a high level of debt creates these risks as debt burdens corporations to pay the borrowed capital back at some point as opposed to equity financing.
[362] *Id.*

corporations, as it would result in corporations incurring higher costs of debt, particularly due to higher interest rates of future borrowings.[363] However, such market-oriented factor might not concern short-term shareholders much since their investment horizons would likely be too short to bear the burden of higher costs of debt in the future. On the other hand, managers are also expected to refrain from wrongdoing for fear of inflicting irrevocable damage on their reputation in the market.[364] However, managers with short-term orientation may find jobs owing to their reputation as shareholder value maximizers, who would pursue policies favouring short-term shareholders at the expense of creditors. Consequently, distribution of too much cash to shareholders via OMRs as a result of aligned interests of managers and short-term shareholder activists with respect to OMRs would also harm creditors.

E. Interim Conclusion

This chapter has summarized the historical development of rules applicable to OMRs in the US. As a consequence of economic liberalism and state competition, US courts have allowed registered corporations to repurchase their own shares, and this approach—colloquially known as the American Rule—was later enacted in the corporation laws of most states throughout the nineteenth century. At the federal level, the Stock Market Crash of 1929 urged the US government to regulate markets, within which a series of federal legislative acts was enacted. These acts contain general rules applicable to repurchases of shares traded on the market. In the post–war era, protective policies continued to reign and the possibility to specifically regulate OMRs has been considered

[363] *Id.* at 1170–71.
[364] *Id.* at 1171.

several times over the period 1967–1980. However, none of the proposed rules have been adopted, as they were found to be too restrictive. This reluctance was in line with the change in political economy at the time, namely the resurgence of liberal economic policies in reaction to global competitive pressures. Such change also led to changes in markets and corporations that precipitated in the emergence of financialization and shareholder capitalism. In this context, OMRs have appeared as beneficial tools for increasingly shareholder-oriented corporations operating in increasingly financialized markets. Thus, OMRs have been (de)regulated with a safe harbor rule since 1982. Since then, the rule was amended only once as part of efforts to increase transparency in the wake of corporate scandals in 2003—the most crucial amendment being the introduction of mandatory disclosure requirements.

The number of OMRs has steadily increased in the last four decades and reached at record levels towards the end of the 2010s. The dramatic increase in the number of OMRs has been attributed to the various functions of OMRs and many hypotheses have been formulated to explain this phenomenon. This chapter has extensively reviewed the functions of OMRs and hypotheses developed based on these functions by categorizing these functions in five main sections. The first function, which is built upon the fact that the dollar value of OMRs has surpassed that of dividends towards the end of the 1990s, has been the efficient distribution of excess cash to shareholders. This efficiency has been attributed to various advantages that OMRs offer over the main payout method, namely dividends. This chapter has concluded that these advantages have been less than anticipated because the number of OMRs have increased when their tax advantage over dividends have decreased and OMRs now offer a slight tax advantage only in certain circumstances; the signalling content of OMRs (particularly OMR announcements) has been lower than other types of repurchases as well as dividend cuts and signalling via OMRs have not always been the most cost-effective method; OMRs, unlike regular dividends and other repurchasing methods, provide flexibility for corporations that could also be provided by special dividends especially when the distributable amount is relatively high; OMRs increase market liquidity only when insiders do not trade on inside information around share repurchase programs; only a limited number of corporations offer DRIPs and use OMRs to supply shares for DRIPs as an alternative to new equity issuances; and OMRs enable corporations to quickly and easily make adjustments in financial metrics by offsetting stock dilution, which could also be accomplished by share cancellations.

Share repurchases led by OMRs also offer other advantages that dividends cannot offer. OMRs bolster executive compensation and benefit managers while mitigating agency costs, particularly monitoring costs that are borne by shareholders. Accordingly, repurchased shares can be kept in treasury so that corporations could later reissue these shares to meet their obligations arising from stock options and awards. Simultaneously, share repurchases increase share prices and EPS and entitle managers to stock options and stock awards that are tied to certain share price and EPS targets in quarterly financial reports. In this context, OMRs appear as the cost-efficient repurchase method as they enable corporations to repurchase their own shares at the market price. Hence, this chapter has corroborated the claim that managers have personal benefits to be taken into consideration when deciding on a corporation's payout policy in that managers may tend to substitute OMRs for dividends, and the positive correlation between the dramatic increase in the number of OMRs and the shift to stock option compensation in the 1990s supports this claim.

Share repurchases also have functions in corporate finance that help managers to enhance shareholder value. First, share repurchases, especially when financed by debt, allow managers to alter the capital structure of corporations and reach an optimal capital structure more easily than share cancellations by increasing debt while decreasing equity. The alteration of capital structure via debt-financed share repurchases would also enable corporations to benefit from tax deductions on interests paid and avoid certain tax obligations like repatriation tax. Such alteration would benefit shareholders since increased debt burden would constrain management and thereby mitigate agency costs. However, too much debt burden would also be risky for corporations. Second and perhaps most importantly, OMRs, unlike other repurchasing methods, enable managers to invest in a corporation’s own shares. Yet such investment financially makes sense only when shares to be repurchased are undervalued and only OMRs enable corporations to repurchase undervalued shares at prevailing market prices without having to pay premium over the market price. On the other hand, a corporation’s decision to invest in its own undervalued shares could be criticized that it contradicts with the rational choice theory and the efficient capital market hypothesis, that managers may not always have the market timing ability that enables them to repurchase shares only when they are undervalued, and that it is not managers’ duty to make investment decisions on behalf shareholders.

OMRs may also deter potential bidders from making hostile takeover attempts. Unlike self-tender offers that may be employed in the course of a hostile takeover attempt, OMRs could be employed in anticipation of hostile takeover attempts. Such deterrence would benefit managers by allowing managers to circumvent takeover attempts and entrench their managerial positions, while debarring shareholders from being informed about the potential bid that might have created added value. This particular function of OMRs explains much of the increase in the number of OMRs in the 1980s when the merger activity was high. Finally, yet importantly, OMRs also supply shares for ESOPs that ties employee remuneration to stock performance of corporations, which is a crucial benefit for employees working in corporations having the corporate governance model that often neglects labour and provides employees weaker representation rights. Overall, this chapter has concluded that OMRs have various functions that may be beneficial for certain corporate stakeholders as well as corporations in certain circumstances, however, the thorough analysis of each function indicates that none of these functions alone is sufficient to explain this increase. Rather, this chapter has conjectured that the combination of all these functions, namely the multifunctionality of OMRs, explains the dramatic increase in the number of OMRs to a large extent, though not entirely.

On the other hand, the potential conflict of interest inherent in managerial authority over OMRs suggests that illegitimate purposes might have also played a role in precipitating an increase in the number of OMR announcements and actual OMRs. Yet, the combination of the inflationary and non–obligatory nature of OMR announcements and the inflationary, bargain, and disproportionate nature of actual OMRs makes them susceptible to exploitation by those who have inside (or superior) information. In this context, managers appear as prime suspects that are able to exploit OMRs at the expense of less-informed shareholders by directly or indirectly engaging in insider trading because they have access to inside information and also have the sole duty to execute OMRs. Despite the potential of market manipulation and insider trading, disclosure requirements are not detailed and timely, the rule applicable to OMRs is a non-exclusive safe harbor rule so that it does not require corporations to abide by the rule and is not directly enforceable, and insider trading rules are not easily enforceable.

Although to a lesser extent than managers, more informed shareholders are also able to exploit OMRs at the expense of less-informed shareholders. Yet institutional shareholders holding larger stakes have more incentives and owe fiduciary duties to actively monitor management and active institutional shareholders would typically have more information than retail shareholders. Additionally, major changes in market regulation as well as corporate governance and business practices pushed through proxy advisory firms have been made to further incentivize institutional shareholders to more actively engage in corporate governance and monitor management. These changes have resulted in the empowerment of institutional shareholders in the assumption that the cost of information acquisition is fixed. Despite the increasing shareholder empowerment, the vast majority of active institutional shareholders, particularly hedge funds, and fall out of the scope of insider trading rules. Thus, this chapter has argued that not only managers but also active institutional shareholders favour OMRs as they both are able to exploit OMRs at the expense of less-informed market actors.

This chapter has also argued that the ability of both managers and active institutional shareholders to exploit OMRs would induce them to use OMRs for their own short-term financial interests and disregard the potential long-term consequences of excessive use of OMRs. Managers have financial incentives to reap personal gains in the short-term via OMRs because OMRs inflate share prices and EPS that would entitle managers to stock options and stock awards that comprise the majority of their compensation. On the other hand, some active institutional shareholders, particularly hedge funds, do not only actively monitor management but also actively engage in business decisions of corporations and pressure managers into executing OMRs. Yet again, the inflationary effect of OMRs on share prices in the short-term would help hedge funds to meet the high-risk high-return investment expectations of their sophisticated investors. Consequently, shareholder activists hold shares for the short-term that would cause them to disregard the long-term consequences of OMRs. Hence, this chapter has demonstrated that the short-term financial interests of managers and short-term shareholder activists—the two interest groups that are supposed to discipline each other—have been aligned with respect to OMRs at the expense of long-term shareholders.

The alignment of short-term interests of managers and short-term shareholder activists with respect to OMRs might cause wealth transfer from corporations and corporate stakeholders having long-term interests to those having short-term financial interests by distorting the payout policies of corporations particularly in terms of amount by causing corporations to squander cash via OMRs. Distributing too much cash via actual OMRs would cause underinvestment that would harm corporations as well as corporate stakeholders having long-term interests, directly or indirectly. These stakeholders include but not limited to long-term shareholders, employees, households in their capacity as taxpayers and consumers, and creditors. In other words, while certain shareholders benefit from OMRs, the excessive use of OMRs would cause underinvestment and harm some other shareholders. Therefore, this chapter has argued that this contradiction refutes the main assumptions of shareholder value theory that shareholders have common interests and the interests of shareholders are aligned with those of corporations, and suggested that shareholders have divergent and even contending interests and some of these interests may even contradict with the best interests of corporations as well.

To sum up, this chapter has suggested that OMRs are essentially beneficial financial transactions but there also are potential drawbacks arising from the abuse of OMRs. That is, managers are able to engage in market manipulation and insider trading and exploit OMRs to the detriment of less-informed shareholders that would ultimately harm markets. Moreover, this chapter has also demonstrated that the alignment of interests of managers and short-term shareholder activists with respect to OMRs joins in the functions of OMRs to fully explain the dramatic increase in the number of OMRs. However, the excessive use of OMRs as a result of such increase would cause underinvestment that would ultimately harm corporations and corporate stakeholders including long-term shareholders. Against all these potential drawbacks associated with the abuse of OMRs, the lack of repurchase-related lawsuits since the adoption of the OMR rule in 1982 supports the claim that the potential of market manipulation and insider trading via OMRs were underestimated by market authorities, which resulted in the adoption of a regulatory framework on OMRs that has been ineffective in eliminating the risk of market manipulation and insider trading around OMRs.

CHAPTER III. LAW AND ECONOMICS OF OPEN MARKET REPURCHASES IN THE EU IN COMPARISON WITH THE US: CONVERGENCE, DIVERGENCE OR BOTH?

A. Introduction

Unlike in the US, share repurchases used to be strictly regulated in the UK and in Continental Europe. In one of its judgments in 1887, the House of Lords in the UK had prohibited a company's purchase of its own shares based on the conclusion that the potential drawbacks arising from the abuse of share repurchases outweighed the purported benefits of share repurchases.[365] This prohibitive view later influenced an EEC directive that was enacted shortly after the accession of the UK into the EEC.[366] This is because many Continental European countries have shared a similar view on repurchases, which has been consistent with the Continental European economic and corporate model. However, at the same time, global competitive pressures forced the EU Member States, starting with the UK, to re–examine their economic and corporate model in order to spur foreign as well as domestic investment. The relative success of the US economic and corporate model following the adoption of neoliberal policies at the beginning of the 1980s also induced most EU Member States to adopt a liberalization policy. Within this scope, EU Member States respectively deregulated certain laws including those on share repurchases in general, and OMRs in particular.[367] In order to harmonize the liberalized company laws of EU Member States, the EU amended and relaxed the EEC directive that used to include the outright ban on share

[365] *See infra* Part B.1
[366] *See infra* Part B.2.
[367] *See infra* Part B.3.

repurchases.[368] This harmonization effort had followed the efforts of the EU to harmonize market laws of EU Member States, in which the EU had issued a directive concerning market abuse and a regulation specifically addressed buy-back programs and stabilisation of financial instruments with reference to market abuse directive.[369] The end result of this harmonization process in the EU has been a regulatory approach that is essentially similar to that in the US with respect to OMRs.

This regulatory approach has enabled EU companies to repurchase their own shares, such that the number of OMRs has increased in the EU even faster than in the US.[370] However, the number of OMRs and the percentage of OMRs to total payout in the EU have not been as high as in the US.[371] The OMR activity has been concentrated in the hands of a few large privatized (formerly state-owned) EU companies,[372] through which US(-style) investors entered into the EU market and employed their highly financialized investment methods and induced companies to frequently execute OMRs. On the other hand, the majority of EU companies persist in the Continental European economic and corporate model. That is, stakeholder-centered companies with insider model of corporate governance continue to operate in countries with bank-based financial systems and coordinated market economies. These companies do not need OMRs as much as their counterparts operating in the Anglo-American economic and corporate setting. Indeed, although the OMR rule in the EU has essentially been the safe harbor rule like in the US, the persistence in the traditional economic and corporate model has caused the OMR rule in the EU to slightly differ

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[368] *See infra* Part B.4.
[369] *See infra* Part B.5.
[370] von Eije & Megginson, *supra* note 4, at 348 (showing that large scale share repurchases started much later in the EU than in the US and have grown more rapidly than in the US over the past decade).
[371] *Id.* (finding that the total value of share repurchases accounts for over half of the total value of cash dividends, although only one-fourth as many European companies repurchase shares as pay cash dividends).
[372] *Id.* at 349 (finding that privatized corporations account for almost one-quarter of the total value of EU cash dividends and share repurchases while representing barely 2% of the number of listed firms).

from that of the US in certain aspects. One of the most crucial differences has been the enumeration of legitimate business purposes for which companies must execute OMRs in order to benefit from the protection offered by the safe harbor rule.[373] However, in fact, companies may execute OMRs for purposes other than those stated in the rule,[374] and even conceal these purposes with purposes articulated in the rule.

Moreover, OMRs executed for any of the purposes might also be illegitimate in that some of the policy concerns discussed in the US context above are relevant in the EU as well. That is, OMRs inflate share prices while disproportionately distributing cash to shareholders. OMRs may also enable companies to engage in false signaling and execute bargain repurchases in the EU, although to a lesser extent than in the US. These features of OMRs would enable managers and shareholders having inside or superior information to engage in informed trading and to exploit OMRs at the expense of less-informed shareholders.[375] Since the OMR regulation in the EU has essentially been similar to the OMR rule in the US, it has been similarly ineffective in eliminating the potential of market manipulation and informed trading. The legal ineffectiveness would cause both managers and shareholders to exploit OMRs and such exploitation might have adverse consequences. Yet, as a consequence of the Americanization trend, managers and certain shareholders in certain EU companies have increasingly had short-term financial interests. These interests of managers and short-term shareholder activists have been aligned with respect to OMRs. Such alignment might cause corporations to excessively execute OMRs that might result in underinvestment, which would harm corporate stakeholders having long-term interests through harming corporations.[376]

[373] *See infra* Part C.1–2.
[374] *See infra* Part C.3.
[375] *See infra* Part D.1.
[376] *See infra* Part D.2.

However, the persistence in the Continental European model is reflected in the OMR regulation through technical differences that make the OMR rule in the EU look stricter than that in the US. More importantly, such persistence causes companies to not repurchase their own shares as much as their US counterparts. Ultimately, since the number of OMRs in the EU has been much less than that in the US, the consequences of OMR-induced underinvestment on companies and their stakeholders would be expected to be less severe than those in the US.

These findings trigger the debate on convergence-divergence with respect to the regulation and uses of OMRs and drawbacks associated with the abuse of OMRs in the EU. Therefore, this chapter consists of three parts and compares the legal framework on OMRs as well as the legitimate business purposes of OMRs and potential drawbacks arising from the abuse of OMRs in the EU in comparison with the US. For this purpose, the first part traces the legal background of OMRs in the EU and examines whether and to what extent the OMR regulation in the EU converged towards the regulation in the US. Based on the legitimate business purposes prescribed by the OMR regulation in the EU, the second part examines the purported benefits of OMRs to determine whether and to what extent OMRs are beneficial in the EU in comparison with the US. Finally, the last part analyzes the potential drawbacks associated with OMRs to explore whether and to what extent OMRs are abused, with an emphasis on whether current rules and regulations on OMRs in the EU have been able to eliminate potential drawbacks arising from the abuse of OMRs in comparison with the US.

B. An Overview of Development of Rules Applicable to OMRs in the EU

In 1887, the House of Lords in the UK mandated that a company could not purchase its own shares unless such a purchase was authorized in its memorandum of association or in the general corporate law statute.[377] This ruling, which is colloquially known as the English Rule (this dissertation chooses to use the term British Rule instead), was contrary to the American Rule that favours the business purposes of share repurchases and allowing corporations to purchase their own shares. The British Rule largely influenced the EU *acquis* following the accession of the UK into the EU.[378] However, initially the UK and later the rest of the EU have been influenced by neoliberal policies of the US. This process resulted in the deregulation of the national rules and regulations on share repurchases and OMRs in EU Member States.[379] As part of the harmonization efforts of the national rules and regulations across the Europe, the EU amended and relaxed the legal capital regime that includes a provision on share repurchases in general,[380] shortly after the adoption of a market abuse directive that refers to a special regulation that (de)regulated OMRs.[381]

This part reviews how the rules on share repurchases, and on OMRs in particular, has transformed from the British Rule—which entails restricting share repurchases—into a much more permissive set of rules. The following analysis thus seeks to explain this complex transformation in five distinct sections. The first section reviews the British Rule and its driving factors. The second section traces the influences of the British Rule on the EU *acquis*, and particularly the company law of the EU. The third section endeavours to examine whether, how and to what extent European economic and corporate systems in general and share repurchases and OMRs in particular has been

[377] *See infra* Section 1.
[378] *See infra* Section 2.
[379] *See infra* Section 3.
[380] *See infra* Section 4.
[381] *See infra* Section 5.

influenced by the Americanization trend. In this context, the fourth section examines how the company law in the EU, which used to include a strict regime on share repurchases, has converged towards the US corporate law while the fifth section examines how the OMR regulation in the EU has converged towards the corresponding regulation in the US.

1. The British Rule on Share Repurchases

While early companies in the UK (and Continental Europe) used to be formed through charters granted by the government, many businesses, which were formed in the Industrial Revolution, used unincorporated partnerships based on trust relationships. However, partnership law of the time posed various disadvantages for larger business enterprises and the legality of the unincorporated joint stock company remained in some doubt.[382] The government had to make a series of statutory interventions, the first of which has officially changed the corporate model from charter companies to registered companies in 1844.[383] Registered companies had not been coupled with the notion of limited liability until 1855.[384] While the notion of limited liability has been regarded as an essential factor to spur investment,[385] it also inhibits the ability of creditors of an insolvent company to hold a corporation's shareholders liable from corporate debt. In order to protect creditors, the notion of limited liability was coupled with a statutory legal capital rule in the UK that consists of various rules, the objective of which has been to form and maintain the capital of the company.[386] However, another UK law abandoned the minimum capital

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[382] CHEFFINS, *supra* note 32, at 148–49.
[383] *Id.* at 164–66.
[384] *Id.*
[385] *Id.* at 148–49.
[386] *Id.* at 165.

requirement—one of the main components of the legal capital rule—and the same law required companies to file a memorandum of association.[387] In this corporate document, companies were required to have an object clause stating the purposes for which the company would be carried on. If managers act beyond the object clause of the company, the relevant action would be void and not legally binding on the company. This rule is colloquially known as the doctrine of *ultra vires*.

In order to protect corporate creditors by maintaining the capital of the company, in 1887 the House of Lords religiously applied the doctrine of *ultra vires* onto share repurchases in *Trevor v. Whitworth*.[388] In this case, one of the shareholders wanted to sell his shares and exit, while the remaining shareholders wanted to keep the company a family concern so that they did not want those shares to be sold to any outside shareholders.[389] However, none of the remaining shareholders was willing to purchase these shares out of their own personal funds. Rather, the remaining shareholders decided to use corporate funds so that the company repurchased more than a quarter of its own shares from the selling shareholder.[390] However, the company went into liquidation before making a full payment to the selling shareholder for the repurchased shares.[391] On this basis, the (executors of the deceased) shareholder, who sold his shares to the company, made a claim against the company for the balance of amounts owed to him.[392]

As plaintiffs also suggested, the company repurchased its own shares from the selling shareholder out of its own funds pursuant to the articles contained in the articles of association that authorized

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[387] *Id.*
[388] Trevor v. Whitworth, (1887) 12 App. Cas. 409.
[389] *Id.*
[390] *Id.*
[391] *Id.*
[392] *Id.*

the company to repurchase its own shares.[393] Although the articles of association clearly authorized the company to repurchase its own shares, the court concluded that such authorization was not in the memorandum of association and not incidental to any of the legitimate objects of the company stated in the object clause of the memorandum of association.[394] Accordingly, it was held that the company's purchase of its own shares was *ultra vires* (beyond the powers of) the company.[395]

Moreover, the court was not convinced of the fact that such purchase should be done out of the funds of the company instead of the personal funds of remaining shareholders. The court argued that using corporate funds for share repurchases is undesirable because (i) retaining repurchased shares instead of reselling them would reduce the corporate capital in a way not defined in the statute and to the detriment of its creditors, and (ii) reselling repurchased shares would constitute a trafficking in shares that was detrimental to markets and shareholders and thereby clearly prohibited by law. Lord Herschell's seminal passage below eloquently summarizes the position of the UK through this matter in firmly working to protect markets and shareholders along with creditors:

> What was the reason which induced the company in the present case to purchase its shares? If it were that they might sell them again, this would be a trafficking in the shares, and clearly unauthorized. If it were to retain them, this would be to my mind an

[393] *Id.* at 409–10 (citing Article 179 of the articles of association stating that any share may be purchased by the company from any person willing to sell it, and at such price, not exceeding the then marketable value thereof, as the board think reasonable, and Article 181 of the articles of association stating that shares so purchased may at the discretion of the board be sold or disposed of by them or be absolutely extinguished, as they deem most advantageous for the company).
[394] *Id.* at 433.
[395] *Id*. at 409.

> indirect method of reducing the capital of the company. The only suggestion of another motive (and it seems to me to be a suggestion unsupported by proof) is that this was intended to be a family company, and that the directors wanted to keep the shares as much as possible in the hands of those who were partners, or who were interested in the old firm, or of those persons whom the directors thought they would like to be amongst this small number of shareholders. I cannot think that the employment of the company's money in the purchase of shares for any such purpose was legitimate. . . . I can quite understand that the directors of a company may sometimes desire that the shareholders should not be numerous, and that they should be persons likely to leave them with a free hand to carry on their operations. But I think it would be more dangerous to countenance the view that, for reasons as these, they could legitimately expend the moneys of the company to any extent they please in the purchase of its shares. No doubt if certain shareholders are disposed to hamper the proceedings of the company, and are willing to sell their shares, they may be bought out; but this must be done by persons, existing shareholders, or others, who can be induced to purchase the shares, and not out of the funds of the company.[396]

Similarly, Lord Macnaghten evaluated repurchases in terms of the market price of shares. He argued that the board apparently did not exercise any judgment on repurchase decisions based on the market price of shares because shares of the company were not sold in the market at the time, and thereby it was nearly impossible to determine the market price of shares.[397] He emphasized that the company borrowed money to repurchase its own shares from its members, who wanted to withdraw, and bought back most of its own shares at a price equal to the par nominal value,

[396] *Id.* at 416–17.
[397] *Id.* at 432.

although the company performed poorly in due course.[398] Thus, such repurchases made at a price above the real value would be detrimental to the finances of the company, whereas repurchases made at a price lower than the real value would be economically unproductive and speculative. In conclusion, the House of Lords took the prohibitive stance—that is now known as the British Rule—towards share repurchases *per se*.

2. The Influence of the British Rule on the EU Acquis

Differences between corporate models of the UK and the US, which also caused the emergence of opposing views on share repurchases in the nineteenth century, continued to exist throughout much of the twentieth century.[399] Interest groups that benefit from the prevailing economic, legal, and corporate system, a reflection of which was the British Rule, remained influential in the UK for the most part of the twentieth century. Most importantly, controlling shareholders (and managers that are appointed by them) remained dominant in the UK longer than the US.[400] Controlling shareholders are insiders that exercise control through voice and prefer reinvestment of corporate profits for expansion. In other words, controlling shareholders would favour neither the distribution of cash to shareholders nor the liquidity to exercise control via exit. Hence, controlling shareholders benefited from the strict ban on share repurchases, a tool that could be used to distribute cash to shareholders and to increase market liquidity for a cost-effective and easy way to exit.

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[398] *Id.*
[399] *See generally* Brian R. Cheffins, *Putting Britain on the Roe Map: The Emergence of the Berle-Means Corporation in the U. K., in* CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 147 (Joseph A. McCahery, Piet Moerland, Theo Raaijmakers & Luc Renneboog eds., 2002).
[400] *Id.* at 153–58.

Other influential interest groups in the UK throughout the most part of the twentieth century have been banks, insurance companies and pension funds, employees, and the state.[401] In the US, investment banking had been disconnected from commercial banking all while criminalizing certain banking activities following the Great Depression.[402] The UK government, however, did not introduce any such major regulation in the wake of the Great Depression.[403] With the rise of institutional ownership in the second half of the twentieth century, insurance companies and pension funds have become dominant investors in the UK rather than investment companies that predominate in the US. Consequently, banks, insurance companies, and pension funds have been relatively powerful corporate stakeholders although banks and insurance companies used to hesitate to directly involve with the ownership and control of UK companies due to financial conservatism.[404] The relevance of banks, insurance companies and pension funds, in turn, reinforced the restrictive approach to share repurchases. Yet, such approach benefits insurance companies and pension funds as investors having asset-liability management constraints and long-term strategic interests and banks as creditors by inhibiting companies from reducing corporate capital through spending cash on share repurchases.

Moreover, as a result of changes in the political landscape in the wake of the World War II, employees in UK companies were empowered against investors by way of various statutory measures that sought to protect employees by bolstering their rights.[405] Employees have been

[401] *Id.* at 159–63.
[402] The Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (June 16, 1933). The relevant sections, however, were repealed by the Gramm-Leach-Bliley Act in 1999. *See* Pub. L. 106-102, 113 Stat. 1338 (Nov. 12, 1999).
[403] Cheffins, *supra* note 399, at 159–60.
[404] *Id.*
[405] *Id.* at 161–62.

another interest group that does not prefer companies to distribute corporate cash to shareholders (via share repurchases). Similarly, most companies operating in infrastructure industries in the UK were established as state-owned enterprises as part of the nationalisation policy that has been the corollary of the political landscape at the time.[406] Share repurchases are also irrelevant to state enterprises, since states typically engage with certain management targets other than return on investment.

In addition, the UK had come under the same roof with Continental European countries under the auspices of the EU and thereby established ties with these countries.[407] Shortly after the UK joined the EU, the British Rule influenced the Second Council Directive 77/91 (SCD) of the EU.[408] The SCD instructs EU Member States to impose a strict regime on share repurchases for the purpose of maintaining corporate capital. The restrictive approach on share repurchases also complies with the Continental European economic and corporate model. In this model, influential interest groups largely overlap with those that remained influential in the UK, and similarly, do not favour share repurchases.

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[406] *Id.* at 162.

[407] *See, e.g.*, Paul L. Davies, *Board Structure in the UK and Germany: Convergence or Continuing Divergence?*, 2 INT'L & COMP. CORP. L.J. 435 (2002) (examining the extent of functional convergence between the German two-tier board and the one-tier UK board as a result of the corporate governance reforms which have occurred in the UK in the 1990s and arguing that these reforms have moved the British one-tier board closer to the two-tier model at a functional level, although there are still significant differences between the German model of the board's functions and the British model).

[408] Second Council Directive 77/91/EEC, of 13 Dec. 1976 on the Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, are Required by Member States of Companies within the Meaning of the Second Paragraph of Article 58 of the Treaty, in Respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital, with a view to Making Such Safeguards Equivalent, arts. 19–22, 1977 O.J. (L 26) 1, 6–8.

Many companies in Continental Europe typically do not bear any resemblance to Berle-Means corporations as their ownership has been concentrated in the hands of a few large controlling shareholders, led by families. These shareholders inherently pursue strategic interests and exercise control via commitment.[409] Therefore, they do not favour share repurchases, which satisfy minority shareholders' financial interests and serve their liquidity needs. As a consequence of ownership concentration, ownership of companies in Continental Europe has not been separated from control until recently. Ownership of many European public companies have now been separated from control. However, those having control of companies, namely managers, have been different than their US counterparts. Managers of European companies have been treated more like salaried employees and have been more attached to controlling shareholders with strategic but more limited bureaucratic authority.[410] For these reasons, managers in Continental Europe have functional orientation rather than financial orientation and greater commitment rather than greater autonomy in relation to the company.[411] Hence, these managers do not favour share repurchases, which typically satisfy US-style managers having financial orientation and greater autonomy by bolstering their compensation and by giving them flexibility in decisions regarding shareholder value maximization, corporate finance, and takeovers.

Moreover, the reaction of Continental European countries against the Great Depression dramatically differed from the US. This reaction caused the differentiation of regulatory approaches in the 1930s that made banks the major source of capital in Continental Europe. Unlike in the US (and even in the UK), banks in Continental Europe directly own shares and exercise

[409] Aguilera & Jackson, *supra* note 28, at 453.
[410] *Id.* at 451.
[411] *Id.* at 457–59.

control over the company via debt and commitment.[412] Therefore, these banks, as relational investors and creditors, would not favour share repurchases. First, share repurchases would inhibit companies to reinvest corporate cash to long-term investment projects that would be beneficial for banks, as relational investors. Second, share repurchases would have the effect of reducing capital that banks, as creditors, rely on. On the other hand, investment through banks and bank-based finance further concentrated financial assets in the banking sector. Such concentration reduced demand for shares by minority shareholders, which further decreased the need for share repurchases.

Furthermore, contrary to antitrust laws that stimulate the active market for corporate control in the Anglo-American setting, companies in Continental Europe collaborate with each other. Dense cooperative networks between companies enable them to have strategic interests and exercise control via commitment.[413] Hence, they do not favour share repurchases that facilitate those having financial interests by inflating share prices and those exercising control via exit by increasing market liquidity. Moreover, dense cooperative networks caused market for corporate control to remain inactive and thereby prevented merger waves that would have resulted in the dilution of ownership. Consequently, collaborative inter-firm relations reinforced the ownership concentration and the controlling positions of shareholders pursuing strategic interests and exercising control via commitment.[414] Once again, these types of shareholders do not favour share repurchases as much as minority shareholders having financial interests and exercising control via exit.

[412] *Id.* at 453–54.
[413] *Id.* at 454.
[414] *Id.* at 461.

Moreover, unlike the Anglo-American corporate model where employees are given financial incentives, employees in Continental European corporate model have stronger representation rights so that they pursue strategies of internal participation in order to codetermine management actions.[415] In this context, employees do not favour share repurchases as they do not prefer companies to distribute corporate cash to shareholders. Yet, shareholder distributions might inhibit companies from reinvesting cash in productive capabilities as well as innovation that enable companies to sustain in the competitive environment and continue to provide employment. Lastly, states have also been one of the largest shareholders in many companies in Continental Europe. States have various social objectives other than generating profits so that they do not favour share repurchases. As a result, the dominance of influential interest groups that do not favour share repurchases enables Continental European countries to align with the UK with respect to the restrictive approach on share repurchases adopted within the Second Council Directive 77/91.

3. Americanization Trend and Its Effects on the Regulation of OMRs

Concurrently with the accession of the UK into the EU, British businesses were transformed due to the market-oriented factors. These factors caused controlling shareholders to exit or consent to dilution of their stake, and induced retail shareholders and later institutional shareholders, primarily pension funds and insurance companies, to enter into the market.[416] The change of ownership caused the ownership dispersion and consequently the separation of ownership and

[415] *Id.* at 455–56.
[416] Cheffins, *supra* note 399, at 155–58.

control—the two main features that are incidental to US corporations—to occur in the UK as well.[417] Consequently, the UK corporate model has converged towards the US and managerial companies arose in the UK by the 1980s.[418] Like in the US, the purported inefficiency of organizational and governance structures of companies in the face of global competitive pressures caused the UK government to liberalize their economic model for a more competitive market environment following the political shift in the 1980s.[419] The liberalization movement in the UK included a comprehensive privatization program, whereby formerly state-run enterprises were sold to private investors. Shares of many privatized companies were acquired first by US-dominated integrated investment banks, and later by hedge funds.[420] Unsurprisingly, these investors sought to encourage managers and boards to employ US-style finance methods, one of which has been share repurchases led by OMRs. Thus, as part of the liberalization policy in the UK, rules on company laws and securities regulation have also been deregulated. These rules included a company law rule in 1981 that allowed UK companies to repurchase their own shares, and subsequently a securities law specifically on OMRs in 1984.[421]

[417] *Id.*
[418] *Id.*
[419] *Id.* at 162.
[420] CHEFFINS, *supra* note 32, at 88–89.
[421] Section 35 of the Companies Act of 1980 in the UK was the first in codifying share repurchases by stating that no company shall acquire its own shares whether by purchase, subscription or otherwise, except for the purpose of reduction of capital, but makes no distinction between on- and off-market repurchases. Sections 45–62 of Companies Act of 1981 vested companies a broader authority to repurchase their own shares. With reference to the Companies Act of 1981, open market repurchases were regulated under Chapter 15 of the Listing Rules in the UK in 1984. Section 166 of the Companies Act of 1985 was the first company law in the UK that explicitly regulates on-market repurchases. Finally, Section 166 of the Companies Act of 1985 has been superseded by Section 701 of the Companies Act of 2006. In addition to this, OMRs are now subject to the listing rule under the Financial Conduct Authority in the UK. See Financial Conduct Authority Handbook, Listing Rule 12.4 (2019) [hereinafter referred to as FCA Handbook].

Around a decade after the UK, many Continental European countries also adopted liberalization policies to attract foreign investors to invest in major state-owned enterprises that were being privatized in the 1990s. As part of these policies, many Continental European countries deregulated market laws and adopted liberal rules, one of which was to allow companies to repurchase their own shares on the open market, like in the US.[422] Functional convergence towards the Anglo-American legal system including but not limited to the regulation on OMRs has also caused partial formal convergence. This is because foreign investors have entered into the EU market mainly through buying shares in the privatizations of a few large EU companies. These foreign investors have particularly been hedge funds from the US that have highly financialized investment strategies and influenced these companies to pursue policies to enhance shareholder value including share repurchases led by OMRs.[423] On the other hand, most EU companies preserved the Continental European corporate model. Thus, financialization that brought along shareholder capitalism, which this dissertation terms as the Americanization trend, has not completely undermined the bank-based financial system, interfirm networks, employee codetermination and collective bargaining institutions.[424] Indeed, evidence on share repurchases confirms such persistence by suggesting that the share repurchase activity in the EU has been

[422] For further information on the initial regulatory approach of EU Member States on OMRs, see Mathias M. Siems & Amedeo De Cesari, *The Law and Finance of Share Repurchases in Europe*, 12 J. CORP. L. STUD. 33 (2012).

[423] Hedge funds that have grown in the US since the 1990s targeted the EU market in the 2000s, in which certain large corporations have been attractive targets since many of them are formed as conglomerates, are cash-rich, and have wide public float, low shareholder attendance, low share price, and/or low growth rate.

[424] For a comprehensive review of the general convergence-divergence debate and an analysis specific to Germany, see Goergen et al., *supra* note 33 (finding a certain functional convergence (especially in the legal framework) suggesting that some governance mechanisms have effectively incorporated aims generally associated with the Anglo-American model, but finding no clear signs of formal convergence, namely the main distinctive features of the German system have remained largely unaltered).

concentrated in the hands of a few large privatized EU companies,[425] which have become targets of foreign investors having highly financialized investment methods.

4. Amendments to the Rule on Share Repurchases

With the expansion of the Americanization trend in the EU throughout the 1990s, the legal capital rule laid out in the SCD, which included the strict provision on share repurchases, was brought into question all over Europe towards the end of the 1990s. Working groups were formed in order to simplify the legal capital rule for a more inclusive regime.[426] In this context, the working groups as well as many previous studies pushed for a more Americanized legal capital regime in the EU. These efforts resulted in the adoption of Directive 2006/68/EC that radically amended the SCD.[427] The Directive introduced numerous changes that directly and indirectly affect the ability of a company to repurchase its own shares. First, the rule that formerly mandated EU Member States to restrict companies from acquiring more than 10% of the subscribed capital (authorized capital) has become advisory. Second, the Directive extended the maximum length of the period, for which authorization for managers to execute share repurchases could be given, from eighteen months to five years.

[425] von Eije & Megginson, *supra* note 4, at 357 (finding that the average amount repurchased by privatized firms is €2 million in 1990, and this rises one-hundredfold to €222 million in 2005, whereas the average share repurchase amount for non–privatized companies increases elevenfold from €1.3 million in 1990 to €14.6 million in 2005).

[426] These working groups are the Company Law SLIM Working Group in 1999 and the High-Level Group of Company Law Experts in 2002. The European Commission issued "A Plan to Move Forward" in which it agreed to the simplifying proposals of the previous panels' reports and promised a scientific study designed to provide the basis for a fundamental revision of the rules governing legal capital requirements in 2003.

[427] Directive 2006/68/EC, of the European Parliament and of the Council, of 6 Sept. 2006 Amending Council Directive 77/91/EEC as regards the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital, 2006 O.J. (L 264) 32.

Directive 2006/68/EC was later recast by Directive 2012/30/EU,[428] and finally redrafted by Directive (EU) 2017/1132 with no changes to the rules on repurchases.[429] The 2017 Directive, like its predecessors, instructs EU Member States to permit companies to repurchase their own shares, provided that the authorization to repurchase shares shall be given to managers by the general meeting.[430] The authorization shall determine the terms and conditions of repurchases and, in particular, the maximum number of shares to be acquired, the duration of a period not exceeding five years for which the authorization is to be given, and, in the case of the acquisition for value, the maximum and minimum consideration.[431] Moreover, the Directive instructs EU Member States to require managers to satisfy themselves when they repurchase shares that such repurchases, including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company's behalf, may not have the effect of reducing the net assets below the amount of the subscribed capital plus non–distributable reserves,[432] and that only fully paid-up shares be included in the transaction.[433]

5. The OMR Regulation in EU Securities Law

[428] Directive 2012/30/EU, of the European Parliament and of the Council of 25 Oct. 2012 on Coordination of Safeguards Which, for the Protection of the Interests of Members and Others, are Required by Member States of Companies within the Meaning of the Second Paragraph of Article 54 of the Treaty on the Functioning of the European Union, in respect of the Formation of Public Limited Liability Companies and the Maintenance and Alteration of their Capital, with a view to Making such Safeguards Equivalent, 2012 O.J. (L 315) 74.

[429] Directive (EU) 2017/1132, of the European Parliament and of the Council of 14 June 2017 relating to Certain Aspects of Company Law, 2017 O.J. (L 169) 46 [hereinafter referred to as Directive 2017/1132].

[430] *Id.* art. 60(1)(a), at 75.

[431] *Id.*

[432] Directive 2017/1132, *supra* note 429, art. 60(1)(b), at 76.

[433] *Id.*

The Americanization trend, which instigated liberalization, privatization and financialization in the UK and later in Continental Europe, also increased the need to regulate the use of financial tools, including OMRs, in the UK and in other EU Member States. For this purpose, EU Member States separately and respectively enacted OMR regulations, with the UK in the 1980s and in many other EU Member States in the 1990s and the beginning of the 2000s. Thereafter, the EU stepped in to harmonize OMR regulations in EU member States.[434] To that end, the EU initially adopted the EU Market Abuse Directive 2003/6/EC (MAD),[435] which was one of the most crucial regulatory pieces for the operation of companies and securities markets.[436]

The MAD aimed at preventing insider dealing and market manipulation by imposing civil and criminal liability on market actors for their misconduct. In this context, the MAD defined OMRs as potentially abusive transactions. However, the MAD also stated that OMRs can be legitimate for economic reasons in certain circumstances and should not be considered as market abuse in themselves as long as they are executed in accordance with certain conditions.[437] However, the MAD did not stipulate these conditions itself. In order to stipulate these conditions as well as other measures and procedures, the European Commission Regulation (EC) No 2273/2003 (EC Regulation) was adopted.[438]

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[434] For more information on the details of OMR regulations of each EU Member State and on the legal comparison of these regulations with the harmonization instruments of the EU, see Siems & De Cesari, *supra* note 422, at 6–10.

[435] Directive 2003/6/EC, of the European Parliament and of the Council of 28 Jan. 2003 on Insider Dealing and Market Manipulation (Market Abuse), 2003 O.J. (L 96) 16 [hereinafter referred to as Market Abuse Directive 2003/6].

[436] In addition to the MAD and the Directive 2006/68/EC, these directives included Directive 2004/25/EC, 2004 O.J. (L 142) 12 (colloquially known as Takeovers Directive); Directive 2004/109/EC, 2004 O.J. (L 390) 38 (colloquially known as Transparency Directive); Directive 2007/36/EC, 2007 O.J. (L 184) 17 (colloquially known as Shareholder Rights Directive); and Directive 2007/44/EC, 2007 O.J. (L 247) 1 (colloquially known as Acquisitions Directive).

[437] Market Abuse Directive 2003/6, *supra* note 435, Recital (33) & art. 8, at 18, 23.

[438] Commission Regulation (EC) No 2273/2003, of 22 Dec. 2003 Implementing Directive 2003/6/EC of the European Parliament and of the Council as regards Exemptions for Buy-Back Programmes and Stabilisation of Financial Instruments, 2003 O.J. (L 336) 33 [hereinafter referred to as EC Regulation 2273/2003].

The EC Regulation, which was the first EU-wide regulation on OMRs, prescribed a safe harbor rule. The rule provided a safe harbor for companies and their insiders from potential liability for market manipulation and insider trading as long as companies execute OMRs for one of the objectives stated in the EC Regulation and in compliance with disclosure rules, trading conditions and restrictions prescribed by the EC Regulation.[439] The safe harbor rule is intrinsically non-exclusive since the rule explicitly states that activities of trading in a company's own shares in repurchase programs, which would not benefit from the exemption under this regulation, should not in themselves be deemed to constitute market abuse.[440]

In this sense, the EC Regulation adopted an approach essentially similar to the safe harbor rules applicable in a few EU Member States that seemed to have originally transcribed the regulatory approach of the SEC Rule 10b-18 in the US. Indeed, there are essential similarities between these two regulations. First, the EC Regulation required companies to report OMR-related information to market authorities and publicly disclose such information after-the-fact, like in the US.[441] However, there was a difference on the nature of disclosure requirements prescribed by these two regulations. In the US, regardless of whether the repurchases are affected in accordance with the safe harbor rule, the reporting and disclosure requirements have been mandatory since 2003. On the other hand, the ex post reporting and disclosure requirements prescribed by the EC Regulation were conditions for companies to benefit from the exemption provided by the safe harbor rule and thereby compliance with these requirements was voluntary in the EU until 2016. The second

[439] *Id.* Recital (1) & arts. 3–6, at 33, 35–36.
[440] *Id.* Recital (1), at 33.
[441] *Id.* art. 4(3)–(4), at 35.

similarity was that, in order to benefit from the safe harbor protection, EU companies had to comply with the trading conditions, namely the price and volume conditions, which are nearly identical to those set out by the Rule 10b-18 in the US.[442] However, unlike in the US, the EC Regulation had not prescribed conditions regarding the manner and timing of OMRs in the EU.

On the other hand, the EC Regulation differed from the Rule 10b-18 in the US by prescribing additional conditions for companies to benefit from the safe harbor rule. First, the EC Regulation required companies to execute OMRs to reduce capital (in value or in number of shares); to meet obligations arising from debt financial instruments exchangeable into equity instruments; or employee share option programs or other allocations of shares to employees of the issuer or of an associate company.[443] Such requirement is absent in the US. Second, in order to benefit from the safe harbor rule, the EC Regulation required companies to disclose the objective of each OMR program as well as the full details of the program prior to the start of OMRs.[444] The details include the maximum pecuniary amount allocated to the program, the maximum number of shares to be acquired, and the period for which authorization for the program has been given. The OMR Rule in the US does not prescribe an ex-ante disclosure requirement. Third, unlike in the US where corporations are required to report their OMR activity to market authorities on a monthly basis in quarterly and annual reports, the EC Regulation prescribed a much timelier ex post disclosure requirement. Accordingly, EU companies are required to publicly disclose each transaction after-the-fact no later than by the end of the seventh daily market session following the date of the execution of the transaction.[445] Finally yet importantly, unlike the OMR Rule in the US, the EC

[442] *Id.* art. 5, at 36.
[443] *Id.* Recital (5) & art. 3, at 33, 35.
[444] *Id.* art. 4(2), at 35.
[445] *Id.* For the details of mandatory disclosure requirement in the US, see *supra* text accompanying note 124.

Regulation imposed trading restrictions on companies during OMR programs.[446] Thus, EU companies shall not sell their own shares, trade their shares during closed periods or when they decide to delay the public disclosure of inside information.

The MAD was later converted into the Market Abuse Regulation (MAR).[447] Unlike the MAD that referred to the EC Regulation to stipulate conditions for repurchasing companies to benefit from the safe harbor rule, the MAR itself stipulates these conditions.[448] The MAR also states purposes, for which OMR programs shall be executed.[449] In addition to the purposes previously enumerated in the EC Regulation, the MAR recognizes supplying shares for executive stock options as another purpose for executing OMRs.[450] Additionally, the MAR delegated its power to the European Securities Market Authority (ESMA) to develop draft regulatory technical standards to specify the requirements OMR programs must meet. These requirements include trading conditions as well as trading restrictions, and disclosure and reporting obligations.[451]

The ESMA drafted regulatory technical standards and submitted them to the EC. The EC adopted the Commission Delegated Regulation 2016/1052 (CDR) in 2016, which repealed the EC

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[446] *Id.* art. 6, at 36.

[447] Regulation (EU) No 596/2014, of the European Parliament and of the Council of 16 Apr. 2014 on Market Abuse (Market Abuse Regulation) and Repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, 2014 O.J. (L 173) 1 [hereinafter referred to as Market Abuse Regulation 596/2014]. For a more detailed explanation of the MAD changing into the MAR, see Eur. Commission, European Parliament's Endorsement of the Political Agreement on Market Abuse Regulation, Sept. 10, 2013, http://ec.europa.eu/commission/presscorner/detail/en/MEMO_13_774. The difference between a directive and a regulation in the EU sense has been that a directive contents with specifying a general objective and a framework and give some leeway to Member States on the adaptation of rules into their national laws, while a regulation seeks a consensus of Member States and thus is directly adopted by Member States with no reservation.

[448] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1), at 22.

[449] *Id.* art. 5(2), at 22.

[450] *Id.* art. 5(2)(c).

[451] *Id.* art. 5(6), at 23.

Regulation.[452] Unlike the EC Regulation that stipulated ex post reporting and disclosure requirements as one of the conditions to benefit from the safe harbor rule, the CDR explicitly states that companies shall not only publicly disclose but also report to the competent authority all OMR transactions regardless of whether the repurchases are effected in accordance with the safe harbor rule.[453] Accordingly, EU companies shall report and disclose their repurchasing activity in a detailed form and in an aggregated form, which shall indicate the aggregated volume and the weighted average price per day and per trading venue, no later than by the end of the seventh daily market session following the date of the execution of the transaction. Lastly, in addition to price and volume conditions prescribed by the EC Regulation, the CDR additionally imposes certain market and timing conditions for OMR transactions,[454] like in the US.

C. Potential Purposes for EU Companies to Execute OMRs

The number of OMRs in the EU has increased even more rapidly than in the US.[455] The average amount repurchased by select EU companies increased from €3.3 million in 1990 to €236.6 million in 2005.[456] This increase occurred after the adoption of the safe harbor rule initially in certain EU Member States (particularly in the UK and in France) and later all over the EU.[457] It was suggested that this trend has been due to legal certainty associated with safe harbor rules in certain EU

[452] *See generally* Commission Delegated Regulation 2016/1052, *supra* note 67.
[453] *Id.* art. 2(2), at 37.
[454] *Id.* art. 3(1), at 37.
[455] von Eije & Megginson, *supra* note 4, at 348, 357, and 372 (showing that large-scale share repurchases started much later in Europe than in the US, but have grown even more rapidly over the last decade).
[456] *Id.* at 357.
[457] Siems & De Cesari, *supra* note 422, at 12 (finding that the propensity to execute stock repurchases generally rises after the implementation of the MAD [and the EC Regulation] in 2003); Sakinç, *supra* note 4, at 12 (emphasizing that share repurchases were intensified after regulatory changes in late 1990s and early 2000s facilitating the share repurchase activity of large European corporations).

Member States and in the EU that increased the propensity of companies to execute share repurchases.[458] This suggestion has been similar to that in the US that the legal certainty came with the safe harbor rule and encouraged corporations to execute OMRs more frequently.[459]

Although the safe harbor rule has enabled companies to execute OMRs and paved the way for another dramatic increase in the number of OMRs, such an increase must have mainly been the corollary of an increased market demand for OMRs. The market demand seems to have come from certain companies. Indeed, the share repurchase activity has been concentrated in the hands of a few large privatized EU companies that were once state-owned.[460] This is mainly because the ownership of these companies has become dispersed as a result of share issue privatizations so that ownership and control has been separated. In parallel to the emergence of Berle-Means corporations, the management of these companies has inherently become oriented towards the Anglo-American corporate model. In this context, US-style investors, which entered into the EU market through investments in these companies, favour share repurchases that have been functional tools for outside shareholders. More specifically, the average amount repurchased by privatized companies was €222 million in 2005 as opposed to the amount of €14.6 million by non-privatized companies in the same year.[461] Consequently, this concentration indicates that the number of OMRs has increased due to reasons similar to those in the US as OMRs appear to have benefits particularly for shareholder-oriented companies operating in financialized markets.

[458] Siems & De Cesari, *supra* note 422, at 18 (suggesting that the value of legal certainty and the positive signal of an EU-wide safe harbor might have had an impact on the propensity of share repurchases).
[459] *See supra* text accompanying note 16.
[460] *See supra* notes 372, 425 and accompanying text.
[461] von Eije & Megginson, *supra* note 4, at 357.

However, unlike in the US, the OMR regulation in the EU enumerates purposes, for which companies must execute OMRs in order to benefit from the safe harbor rule. Accordingly, the MAR explicitly states that companies must perform OMRs only for the purpose of (i) reducing capital, or meeting obligations arising from (ii) debt financial instruments exchangeable into equity instruments or (iii) employee share option programs, or other share allocations to employees or to members of the administrative, management or supervisory bodies of the issuer or of an associate company.[462] The MAR also requires companies to include the objective of each OMR program in their ex ante public disclosures, which are voluntary in nature.[463] Nevertheless, companies may choose to execute OMRs for purposes other than those specified in the MAR. This is because OMRs that are executed beyond the specified purposes would not directly constitute market abuse but only cause companies to not benefit from the protection offered by the safe harbor rule.[464] This regulatory approach enables companies to easily conceal their real intent with one of the purposes stated in the MAR. For instance, companies may state that they repurchase their own shares for the purpose of reducing capital, and it would automatically result in the distribution of cash to shareholders or any other purposes discussed within the context of the US.

Hence, the following section comprises an evaluation of this motivational agenda vis-à-vis purported benefits of OMRs in European context in contrast with the American one. The first section starts with a discussion on the purpose of a company to execute OMRs for the reduction of corporate capital. The second section reviews the function of OMRs in supplying shares, which are repurchased and held as treasury shares that are available for reissuance, to allow companies

[462] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(2), at 22.
[463] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1)(a), at 36.
[464] Market Abuse Regulation 596/2014, *supra* note 447, Recital (12), at 3.

to meet certain obligations. The third section, in comparison to the purported benefits of OMRs discussed in the US, examines other functions of OMRs—that have not been recognized by the MAR—that EU companies might implicitly use them for.

1. Reducing Corporate Capital

OMRs may serve to reduce the capital of a company. Unlike in the US where the legal capital rule has been abandoned or diminished, the legal capital rule has still been in force in the EU. The rule requires companies to have a minimum capital, strictly regulates changes in corporate capital, and substantially limits distributions to shareholders that would reduce capital.[465] By doing so, the legal capital rule seeks to protect shareholders, and above all voluntary and involuntary creditors. Yet, these interest groups have been crucial within the Continental European corporate model, where companies are dominated by controlling shareholders including banks that have also been the main source of capital. Hence, these interest groups do not favour capital reduction especially for the purpose of distributing cash to shareholders in any form including share repurchases. In this context, share repurchases appear as a more problematic distribution method since it might also prejudice the principle equal of treatment of all shareholders that are in the same position.

However, companies may still want to reduce capital to reach an optimal capital structure, namely the most financially effective debt-equity ratio. In these cases, EU companies may reduce capital through share repurchases. Thus, the EU has recognized the capital reduction as one of the

[465] *See generally* Directive 2017/1132, *supra* note 429, arts. 44–86, at 70–85.

purposes of executing OMRs.[466] Moreover, OMRs, if financed by debt, would enable companies to reach optimal debt-equity ratio by not only decreasing equity but also increasing debt. However, unlike the US where corporations issue debt to finance buybacks rather than paying taxes by repatriating excess cash held overseas, executing debt-financed OMRs to avoid repatriation taxes has not been a common practice in the EU.[467] More importantly, EU companies may hesitate to debt-finance OMRs more than their counterparts in the US. This is because, EU companies operate in countries having bank-based rather than market-based financial systems so that they would inherently be concerned more about refinancing risks and credit rating downgrades associated with an increase in debt than distributing cash to shareholders.[468]

2. Supplying Treasury Shares

EU companies may also need OMRs to supply shares for various reasons by reissuing shares repurchased at a later date. Although the primary option to supply shares would be to issue new shares, OMRs appear as a more practical and cost-effective alternative to new equity issuances in supplying shares without diluting ownership percentage of shareholders. For this purpose, most EU Member States now allow companies to keep their repurchased shares as treasury shares, instead of cancelling/retiring them, and to reissue them at a later date as long as shareholders authorize the sale of treasury shares.[469] The MAR enumerates purposes for which EU companies

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[466] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(2)(a), at 22.
[467] Atkins, *supra* note 215 (stating that the practice of US corporations to issue debt to finance buybacks rather than incurring hefty tax bills by repatriating excess cash held overseas has not been an obvious trend in Europe).
[468] *See id.* (arguing that European companies might worry about future refinancing risks and credit rating downgrades if they issue much debt).
[469] Amedeo De Cesari et al., *Stock Repurchases and Treasury Share Sales: Do They Stabilize Price and Enhance Liquidity?*, 17 J. CORP. FIN. 1558 (2011) (claiming that, based on the evidence from Italy, keeping repurchased shares in treasury gives corporations greater flexibility to manage their capital by enabling them to use repurchased shares

could reissue treasury shares repurchased via OMRs, while staying within the safe harbor rule. This section reviews these circumstances. The first subsection explains that EU companies may reissue treasury shares in order to meet obligations arising from debt financial instruments that are exchangeable into equity instruments. The second section explains that treasury shares can be used for ESOPs. And more recently, the MAR has recognized that companies may also repurchase their own shares for the purpose of supplying shares for executive stock options.

2.1 Supplying Shares for Exchangeable Debt Instruments

The EC Regulation 2273/2003, and subsequently the MAR, have recognized the function of OMRs in supplying shares to allow companies to meet their obligations arising from debt financial instruments that are exchangeable into equity instruments. These instruments have been a particular type of convertible debt instruments, which are hybrid instruments that combine at least two different financial instruments.[470] However, unlike other convertible debt instruments that entitle debtholders to convert debt into the equity of the company issuing these instruments, exchangeable debt instruments are exchangeable into the equity of a (target) company other than the issuing company, in which issuing companies have ownership position.[471]

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as currency in future acquisitions, to reissue them at a later date at a relatively low cost, to increase their stock liquidity and to reduce short-term price instability and thereby smoothing the price discovery). *See also* Dimitris Andriosopoulos & Meziane Lasfer, *The Market Valuation of Share Repurchases in Europe*, 55 J. BANKING & FIN., June 2015, at 327 (arguing that one of the reasons for the lower market reaction to the initial announcement of OMR plans in the UK in comparison to the US has been the regulatory reform that allowed UK firms to keep the repurchased shares as treasury stock).

[470] Brad M. Barber, *Exchangeable Debt*, 22 FIN. MGMT., Summer 1993, at 48.

[471] *Id.*

Thus, in order for OMRs to be used to supply shares for companies to meet their obligations arising from exchangeable debt instruments, issuing companies must have controlling positions in target companies, shares of which are publicly traded like those of issuing companies. Accordingly, these companies would likely be parent companies that issue debt financial instruments exchangeable into equity instruments of their subsidiaries. Alternatively, states—through a state-owned enterprise—may issue debt securities exchangeable into shares of another state-owned enterprise. These issuers may want to issue exchangeable debt when they want to divest or sell a large stake in a company, in which they own shares. Exchangeable debt instruments would help issuers to discount the negative market perception associated with divestments and share sales. Exchangeable debt instruments also enable issuers to save on tax as interest payments can be tax deductible.

In this context, if debtholders want to exchange debt instruments into equity instruments, issuing companies are obliged to allocate shares to the debtholder upon their submission. Instead of issuing new shares to meet this demand, issuing companies may have target companies repurchase their shares on the open market, list these shares as treasury shares and later reissue them in order to satisfy debtholders' demand. This study anticipates that, since both holding companies and state-owned enterprises have been commonly used corporate forms in the EU, the function of OMRs in supplying shares to enable issuers to meet their obligations arising from debt financial instruments that are exchangeable into equity instruments have been expressly defined both by the EC Regulation 2273/2003 and now the MAR in the EU.

2.2 Supplying Shares for ESOPs

EU companies may use OMRs to supply shares for ESOPs, which have been prevalent financial participation schemes in the US.[472] However, unlike the US, most EU Member States vest strong representation rights to employees so that employees pursue strategies of internal participation.[473] As for financial incentives, EU companies usually implement performance-based pay schemes rather than financial participation schemes including ESOPs,[474] and in cases when they implement financial participation schemes, they traditionally use profit-sharing plans rather than ESOPs.[475] Unlike ESOPs,[476] profit sharing plans allow employees to choose how to invest or spend cash paid within plans. Profit sharing plans also give employees a voice in the selection of investments and a chance to accumulate retirement funds. However, in line with the changing landscape as part of the Americanization trend, the EU, through the EC Regulation 2273/2003 and subsequently the MAR, has also recognized ESOPs, and thereby OMRs appear as a convenient alternative in supplying shares for ESOPs.

2.3 Supplying Shares for Executive Stock Options

Like in the US, managers in the EU have historically tended to reinvest cash in any investment projects instead of distributing cash to shareholders.[477] However, unlike in the US, managers of

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[472] *See supra* Chapter II.C.5.
[473] Aguilera & Jackson, *supra* note 28, at 455–56.
[474] EUR. FOUND. FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS, EUROPEAN COMPANY SURVEY 2009: OVERVIEW 33–36 (2010), *available at* http://www.eurofound.europa.eu/publications/report/2010/working-conditions-industrial-relations/european-company-survey-2009-overview.
[475] *Id.* at 36–44.
[476] *See supra* note 232 and accompanying text.
[477] Enriques & Macey, *supra* note 27, at 1202.

EU companies also tend to align with controlling shareholders,[478] whose controlling stakes induce them to prefer corporate cash to be spent on investment projects rather than an increase in shareholder distributions. Therefore, managerial tendency towards reinvestment of cash into investment projects has been observed more widely in Europe than in the US. However, in line with the changes in corporate ownership and increasing shareholder value ideology as part of the Americanization trend, US(-style) institutional shareholders that have more recently invested in EU companies pressure managers to distribute cash to themselves and to pursue policies that would enhance shareholder value.[479]

In order to align interests of managers with financial interests of these shareholders, managers have been given financial incentives to have regard to the shareholders' financial interest. In this context, a part of executive compensation in the EU has increasingly been tied to share price performance of the company via stock options and stock awards, like in the US.[480] For this purpose, EU companies would need to supply shares to meet obligations arising from stock options and stock awards. Consequently, in 2014, the MAR has recognized this particular function of OMRs and extended the safe harbor protection to companies that execute OMRs to meet their obligations arising from supplying shares for executive stock options.[481]

3. Other Purposes for Executing OMRs

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[478] *Id.*

[479] *See supra* Part B.3.

[480] *See generally* EUR. FOUND. FOR THE IMPROVEMENT OF LIVING AND WORKING CONDITIONS, *supra* note 474, at 36–44; Patricia Kotnik et al., *Executive Compensation in Europe: Realized Gains from Stock-Based Pay* (Inst. for New Econ. Thinking, Working Paper No. 78, July 13, 2018), *available at* http://ssrn.com/abstract=3228809.

[481] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(2)(c), at 22.

OMRs that are executed for the purposes examined above inevitably serve other purposes, which were largely discussed within the context of the US. Yet, these purposes have been crucial particularly in the Anglo-American context, namely, for shareholder-oriented companies operating in highly financialized markets. More specifically, companies in the EU may announce that they will repurchase their own shares on the open market for one of the purposes stated in the MAR, but such repurchase would also result in the distribution of cash to shareholders, the investment in undervalued shares, the entitlement of managers to stock options and stock awards, and/or the deterrence of unwanted takeover attempts. Thus, the fact that OMRs simultaneously serve many functions allows companies to execute OMRs primarily for one of the purposes that are not specified in the MAR, and to easily conceal their primary purpose(s) with one of the purposes specified in the MAR in order to benefit from the safe harbor rule.

As a matter of fact, even if companies fall outside the scope of the safe harbor rule, market authorities would not start an investigation. Yet, the safe harbor rule is not the exclusive means of executing OMRs. Indeed, the MAR states that OMRs, which would not benefit from the exemption under the safe harbor rule, should not necessarily be deemed to constitute market abuse.[482] Similarly, shareholders, who usually regard OMRs as beneficial transactions and react to OMRs positively, are not expected to make allegations based on market manipulation and informed trading via OMRs. Hence, companies are able to execute OMRs for purposes other than those stated in the MAR and thereby this section reviews these other purposes in four subsections and examines whether and to what extent EU companies would consider these purposes while executing OMRs in comparison with their counterparts in the US.

[482] *Id.* Recital (12), at 3.

3.1 Distributing Cash to Shareholders

In order to execute OMRs for any of the purposes stated in the MAR, a company inevitably repurchases its own shares from shareholders so that it would end up distributing cash to selling shareholders. Shareholder distributions would reduce corporate capital available to managers to make new investments that would ultimately benefit controlling shareholders,[483] and to meet creditors' claims as well as implicit claims of other stakeholders.[484] Hence, most companies in the EU, which are characterized by ownership concentration, stakeholder-centered corporate governance and bank-based financing, do not favour shareholder distributions as much as their counterparts in the US.[485] However, in line with the emergence of shareholder capitalism and financialization as part of the Americanization trend, shareholder distributions have increased across the EU (see Appendix 2),[486] even though the number of total distributions in the EU has still been lower than that in the US.[487]

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[483] Enriques & Macey, *supra* note 27, at 1202.
[484] Mark E. Holder et al., *Dividend Policy Determinants: An Investigation of the Influences of Stakeholder Theory*, 27 FIN. MGMT., Autumn 1998, at 73 (focusing on dividend payout practices of corporations with highly influenced stakeholders other than investors and finding that these corporations have lower dividend payout ratios in order to be able to meet implicit claims of these stakeholders).
[485] von Eije & Megginson, *supra* note 4, at 349, 372 (finding that firms headquartered in a common law country are more likely to pay cash especially via dividends more than corporations incorporated in civil law countries).
[486] Sakinç, *supra* note 4, at 12–13 (reporting data showing an increase in shareholder distributions in the EU).
[487] *Id.* (comparing total payouts of large EU corporations with those of US corporations and showing that large US corporations distribute cash more than their EU counterparts especially since 2014 mainly due to the record-breaking number of share repurchases by large US corporations as well as the depreciation of the Euro currency against US dollar during the same period). *See also* P. Raghavendra Rau & Theo Vermaelen, *Regulation, Taxes and Share Repurchases in the United Kingdom*, 75 J. BUS. 245, 280 (2002) (concluding that, although the UK is the leading country in the EU where buybacks are most popular, the extent of repurchase activity is tiny in comparison with that in the US). This is because, though the UK economic and corporate model has been converging towards the US model, there still have been differences between the corporate governance mechanisms in the UK and the US. A relevant example would be that institutional investors that are less short-term oriented in the UK when compared to those in the US, which results in the reduced investor demand on repurchases. For further information on the differences

The increase in shareholder distributions in the EU has been caused by an increase in the number of both dividends and share repurchases.[488] Despite the dramatic increase in the number of share repurchases, dividends have still been the most common payout method in the EU, unlike in the US.[489] This has been the case even in privatized companies in the EU, which have been responsible for the most of the repurchasing activity in the EU.[490] The ongoing preference of EU companies for dividends over share repurchases indicates that the potential advantages of repurchases over dividends in the context of the US have been absent in the EU or have not been determining factors in payout decisions of EU companies.

The dramatic increase in the number of repurchases suggests that share repurchases in the EU also offer certain benefits similar to those in the US. Accordingly, subject to country-, firm-, and shareholder-specific variables,[491] share repurchases may provide a more tax efficient distribution

between the corporate governance mechanisms in the UK and the US, see Ruth V. Aguilera et al., *Corporate Governance and Social Responsibility: A Comparative Analysis of the UK and the US*, 14 CORP. GOVERNANCE INT'L REV. 147 (2006).

[488] von Eije & Megginson, *supra* note 4, at 348 (finding that, while the fraction of European firms paying dividends declines, the total real dividends paid by dividend-paying firms increase and share repurchases surge in the EU, like in the US).

[489] *Id.* at 355 (reporting that, despite the surge in number of share repurchases, share repurchases represent slightly more than 50% of real cash dividends and 34% of total payout in 2005); Sakinç, *supra* note 4, at 15 tbl.3 (reporting that share repurchases of 298 S&P Europe 350 companies represent 33% of real cash dividends and 19% of net income between the period 2000–2015).

[490] *Id.* at 357 (reporting that average cash dividend payments were €308 million, whereas the average amount repurchased by privatized firms was €222 million for the 83 privatized companies in 2005).

[491] *Id.* at 368–69 (finding that the maturity level of a corporation increases the likelihood of cash payouts, whereas increasing fractions of retained earnings to equity do not); Mohammed Alzahrani & Meziane Lasfer, *Investor Protection, Taxation, and Dividends*, 18 J. CORP. FIN. 745 (2012) (finding that the effect of change in tax policy has different magnitudes in different countries depending on the level of investor protection in that countries with stronger investor protection like in the UK, corporations prefer to repurchase more shares to maximise their shareholders' after-tax returns, especially when agency costs are lower than the tax costs of dividends whereas investors seek to extract as many dividends as they can in countries with weaker investor protection).

method than dividends so that EU companies may prefer OMRs to distribute cash to shareholders.[492] Moreover, even in the case of tax parity between dividends and repurchases, repurchases provide shareholders a slight tax advantage and flexibility.[493] Yet, in case of repurchases, shareholders pay taxes only when they want to sell their own shares and only on the capital gains, namely on the difference between the selling price and the purchase price, which may be negative. On the other hand, shareholders have to pay taxes on the entire amount of dividends in the tax year in which the dividends are received.

As in the US, another potential reason for EU companies to use repurchases would be signaling undervaluation. When information asymmetries exist between inside and outside shareholders and lead to undervaluation, managers tend to take actions that would convey information, signal undervaluation, and increase share prices. Managers would want to increase share prices for various reasons. These reasons include but not limited to the maximization of shareholder value, new share issuances at more favorable prices, and the entitlement of themselves to stock options and stock awards. However, these reasons have been less probable for most EU companies having Continental European corporate model than those having Anglo-American corporate model. Nevertheless, managers of EU companies may want to increase share prices through actual share repurchases as well as ex ante announcements on share repurchases.

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[492] von Eije & Megginson, *supra* note 4, at 351–52 (citing that there were no major changes in cash dividend taxation policies in the EU, whereas both the EU and EU Member States reduced tax burdens on share repurchases during the study period). More specifically, for the discussion on the tax aspect of share repurchases in the UK, see Rau & Vermaelen, *supra* note 487 (finding that, by relying on the policy choice that reduced the attractiveness of cash dividends for pension funds, the repurchase activity in the UK has increased, and arguing that the tax system and the tax treatment of certain investors, such as pension funds that are the largest single shareholder group in the UK, determines the payout policy).
[493] Fried, *supra* note 43, at 1337.

First, managers may consider signaling information via actual share repurchases. Yet, share repurchases indicate that companies have excess cash to be distributed cash to shareholders and that the management thinks that shares are undervalued. Hence, share repurchases would typically convey positive non–public information about the finances of companies to outside shareholders. Moreover, OMRs, as the most bargain and thereby common repurchasing method, enable companies to signal undervaluation cost-effectively. For this reason, market actors in the EU usually react to OMR announcements positively.[494] However, corporations may signal undervaluation via auditors' reports and corporate earnings forecasts at a cheaper price than OMRs, or they may more effectively signal undervaluation via insider purchases that are expected to convey more credible information than share repurchases.[495]

Prior to comparing the signalling power of OMR-related corporate announcements in the EU with those of the US, it should be noted that rules applicable to OMRs in the EU prescribe more corporate announcements than that in the US. These announcements include an initial statement of intention to obtain the shareholders' general meeting authorization for a share repurchase program, a repurchase resolution passed by shareholders at a general meeting, and an ex-ante disclosure requirement just before actual share buyback transactions. As all of these announcements take place before actual repurchases, they are comparable to announcements of OMR plans prescribed by each securities exchange in the US.

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[494] Andriosopoulos & Lasfer, *supra* note 469 (finding a positive market reaction to OMR announcements across major European countries in line with previous evidence based on country-specific studies).

[495] Dimitris Andriosopoulos & Hafiz Hoque, *Directors' Purchases 'Talk' and Share Repurchases 'Whisper'?* (Social Sciences Research Network Working Paper, July 2, 2018), *available at* http://ssrn.com/abstract=2517323 (finding that, based on data from the UK, directors' purchases are preceded by larger share price drops and trigger a better short- and long-term market performance than share repurchases and suggesting that directors' purchases are associated with market timing hypothesis whereas share repurchases are associated with price support hypothesis).

Like OMR announcements in the US, these announcements do not oblige companies to actually repurchase shares. The non-obligatory nature of these announcements is likely to discount their signaling power. Moreover, the signalling power of these announcements in the EU has been even lower than that in the US due to various country-specific factors, which fail to increase credibility, reduce information asymmetry, and thereby increase market reaction.[496] However, EU companies may choose to signal information via OMR announcements precisely because of this reason. That is, the non–obligatory nature of these announcements enables companies to signal information with no cost.

On the other hand, the latter disclosure requirement that has been prescribed by the EC Regulation (and later the MAR) typically causes a much higher market reaction. Yet, the information content of the particular announcement requirement would inherently be more credible since it requires companies, which would want to benefit from the safe harbor protection, to make a disclosure just before the start of the trading within the OMR program.[497] Consequently, EU companies may either use initial announcements on OMRs that allow them to weakly signal undervaluation with no cost, or use announcements that would likely be followed by actual OMRs to strongly signal undervaluation that would come at a cost.

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[496] Andriosopoulos & Lasfer, *supra* note 469 (finding that the average market reaction to OMR announcements across major European countries is lower than in the US mainly due to the relatively large number of recurring announcements that generate significantly lower returns than the initial announcements of intention to repurchase shares, (ii) the specific governance and corporate cultural issues particularly in France, and (iii) the regulatory reform that allowed firms to keep the repurchased shares in treasury based on evidence from the UK).

[497] Andreas Hackethal & Alexandre Zdantchouk, *Signalling Power of Open Market Repurchases in Germany*, 20 FIN. MKT. & PORTFOLIO MGMT. 123 (2006) (finding that abnormal stock price returns around the date of announcements of imminent OMR transactions are four times higher in Germany than those around OMR announcements in the US).

The lack of commitment of OMR announcements would reduce their credibility but increase flexibility for companies in distributing cash to shareholders.[498] Such flexibility allows managers to decide whether, when and how much cash should be distributed to shareholders depending on time-varying factors. More importantly, the flexibility enables managers to distribute non–recurring cash flows via OMRs,[499] instead of dividends that would cause shareholders to expect that they continue to get paid at high level on a regular basis. This preference has mainly been due to the negative market reaction associated with dividend cuts that make managers reluctant to increase dividends to unsustainable levels that would later compel managers to reduce dividends. However, managers may also distribute non–recurring cash flows via special dividends, which inform shareholders that they are non–recurring payments.[500] On the other hand, OMRs have been more cost-effective than dividends only when the distributable amount is low.[501] This is because transaction costs of OMRs increase with the amount to be distributed, whereas costs associated with dividends are fixed.[502] Hence, EU companies may use OMRs to distribute small amounts of non–recurring cash depending on market-, industry-, and firm-specific factors.

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[498] *See supra* Chapter II.C.1.3.

[499] *See* Dennis Oswald & Steven Young, *Share Reacquisitions, Surplus Cash, and Agency Problems*, 32 J. BANKING & FIN. 795 (2008) (claiming, based on data from the UK, that corporations use share repurchases as flexible tools for distributing transitory cash surpluses, which help alleviate agency costs of surplus cash by restricting management's scope to waste corporate resources mainly due to better managerial incentive alignment and closer monitoring by external shareholders). *See also* Bong Soo Lee & Jungwon Suh, *Cash Holdings and Share Repurchases: International Evidence*, 17 J. CORP. FIN. 1306 (2011) (examining the patterns and determinants of share repurchases in seven major countries—Australia, Canada, France, Germany, Japan, the UK, and the US—over the period 1998–2006, and finding that, although US corporations repurchase shares more than any other corporations, corporations in all these countries use share repurchases as a flexible means of distributing non–recurring cash that would also reduce agency conflicts).

[500] Fried, *supra* note 43, at 1338.

[501] *Id.*

[502] *Id.*

OMRs may also increase market liquidity because companies executing OMRs appear on the market as buyers of their own shares and create a demand on the buy-side.[503] Such demand would reduce costs of market makers that would decrease bid-ask spread and increase liquidity in certain circumstances.[504] Reduced bid-ask spread and increased liquidity would benefit shareholders by increasing their ability to cheaply and quickly trade their shares at a fair price. Such liquidity would ultimately benefit companies by mitigating their cost of capital owing to the increased market demand to newly issued shares.[505] However, most EU companies operate in coordinated market economies with bank-based finance and rely on patient capital so that they would not be concerned about increasing market liquidity as much as their US counterparts. On the other hand, with the advent of shareholder capitalism, marketization, and financialization as part of the Americanization trend, some EU companies may want to execute OMRs to increase market liquidity. In this context, increasing market liquidity via OMRs might be necessary particularly for EU markets with extreme low liquidity. Thus, the EC Regulation had authorized EU companies to exceptionally exceed the daily repurchasing limit when the market liquidity was extremely low.[506]

Lastly, OMRs supply shares for DRIPs (dividend reinvestment plans) and offset dilution arising from shares supplied for various reasons including but not limited to DRIPs. Companies offer

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[503] *See supra* Chapter II.C.1.3.

[504] De Cesari et al., *supra* note 469 (studying the effects of OMRs as well as shareholder approvals of repurchase programs on liquidity and volatility in Italy during the period 1997–2004 and finding that OMRs reduce bid-ask spread and increase liquidity when it is low and reduce short-term price instability). *But see* Edith Ginglinger & Jacques Hamon, *Actual Share Repurchases, Timing and Liquidity*, 31 J. BANKING & FIN. 915 (2007) (finding that, based on the OMR activity of French corporations, OMRs have a significant adverse effect on liquidity as measured by bid–ask spread as OMRs largely reflect contrarian trading rather than managerial timing ability).

[505] Stout, *supra* note 209, at 683–84; Butler et al., *supra* note 210.

[506] EC Regulation 2273/2003, *supra* note 438, art. 5(3), at 36. However, this explicit exception was not restated by the CDR in 2016. Nevertheless, market authorities in the EU may establish an accepted market practice if the market practice has a positive impact on market liquidity and efficiency. *See* Article 13(2)(c) of the MAR.

DRIPs to shareholders. Shareholders enroll in DRIPs to simplify the process to reinvest their cash dividends back to corporate shares instead of getting paid in cash. In order to supply shares for DRIPs, companies may repurchase their own shares on the open market as an alternative to new share issuances.[507] Shares supplied for DRIPs as well as for the purposes recognized by the MAR would increase the number of outstanding shares and dilute the ownership percentage of shareholders. Existing shareholders would typically be dissatisfied with any dilution in their ownership percentage. Shareholders are sought to be insulated from dilution through pre–emption rights in the EU. However, pre–emption rights help shareholders to maintain their ownership percentage only if shareholders can afford to purchase a percentage of newly issued shares that is equal to their ownership percentage. Therefore, pre–emption rights fail to protect shareholders when they have no financial means to purchase additional shares. On the other hand, managers may offset dilution via OMRs as OMRs have the effect of decreasing the number of outstanding shares. Hence, the antidilutive function of OMRs would also be crucial for shareholders so that EU company may want to execute OMRs to offset dilution.

3.2 Investing in Undervalued Shares

OMRs seemingly executed for one of the purposes stated in the MAR may enable companies to invest in their own shares when managers think that shares are undervalued. If share prices continue to remain undervalued even after OMR announcements, companies would execute OMRs and repurchase their own shares. However, as noted earlier, the regulatory framework in the EU prescribes a more rigorous disclosure requirement mainly due to the additional ex ante disclosure

[507] *See supra* Chapter II.C.1.5.

requirement that obliges companies, which want to benefit from the safe harbor rule, to publicly disclose information on OMRs prior to the start of trading in an OMR program. This disclosure requirement would substantially limit the ability of companies to repurchase their own shares at a discount by causing share prices to inflate before the execution of OMRs.[508] Rather, this disclosure requirement, which would likely be followed by actual OMRs, appears as a more credible mechanism for signalling undervaluation in the EU.[509]

Nevertheless, there might be instances, in which the market insists on underreacting to ex ante disclosures. In these instances, companies would be able to repurchase their undervalued shares.[510] Though the undervaluation hypothesis is inconsistent with the main assumptions of modern finance,[511] repurchasing undervalued shares via OMRs would theoretically benefit companies and non–selling shareholders provided that managers accurately and conservatively calculate the undervaluation. Yet, investing in undervalued shares might come at the expense of alternative investments, the return of which would be higher than the cost of capital. Hence, although a few

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[508] Hackethal & Zdantchouk, *supra* note 497, at 148–49 (measuring abnormal price effects around two events, namely the initial statement by a German firm that it plans to establish a repurchase plan and the firm's subsequent announcement that it intends to repurchase shares over the open market, and finding that total abnormal returns around these two events add up to roughly 12% and are much higher than the 3% typically reported for repurchase announcements in the US). *See also* Rau & Vermaelen, *supra* note 487, *passim* (claiming that the strict regulation on OMRs may impede managers from using superior information to repurchase undervalued shares). It should be noted that the UK study covers the period before the adoption of the MAD. However, the MAD is claimed to prescribe even much narrower safe harbor rule than the old safe harbor rule in the UK. *See* Siems & De Cesari, *supra* note 422, at 43 fig.1, 44, 55–56 (arguing that the old safe harbor rule before the MAD had a wider scope in the UK and thereby expecting less repurchases in the UK after the MAD whereas finding that the number of repurchases has increased in the UK after the adoption of the MAD).

[509] Hackethal & Zdantchouk, *supra* note 497 (finding evidence indicating that German managers primarily buy back shares to signal an undervaluation of their firm).

[510] Dennis Oswald & Steven Young, *What Role Taxes and Regulation? A Second Look at Open Market Share Buyback Activity in the UK,* 31 J. BUS. FIN. & ACCT. 257 (2004) (finding that, despite the regulatory restrictions in the UK that make it less likely for corporations to use superior information to buy back shares when they are undervalued, underpricing still represents an important determinant of repurchase activity).

[511] *See supra* Chapter II.C.3.2.

companies in the EU might prefer investing in undervalued shares, most EU companies that are largely financed by banks would be expected to show no interest in such highly financialized and speculative investment decisions. Such decisions might result in the reduction of corporate earnings and the missing out on investment projects, all of which would be detrimental to the influential interest groups in the Continental European corporate context.

3.3 Entitling Managers to Stock Options and Stock Awards

OMRs that are executed for one of the purposes specified in the MAR would also inflate share prices and EPS and entitle managers to stock options and stock awards. First, OMR-related announcements inflate share prices. This is because these announcements increase market demand by signalling that a company has excess cash that would be distributed to shareholders and managers think that shares are undervalued. Moreover, actual OMRs increase marginal price by reducing outstanding number of shares and allowing companies, if stock demand curves are downward-sloping, to repurchase their own shares from shareholders, whose share valuation is lower.[512] Reduction in the number of outstanding shares via OMRs may also increase EPS. Second, the inflationary effect of OMRs on share prices and EPS would entitle managers to stock options and stock awards, which are tied to certain share price and EPS targets in periodic financial reports.[513]

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[512] Stout, *supra* note 158, at 489–90.

[513] Steven Young & Jing Yang, *Stock Repurchases and Executive Compensation Contract Design: The Role of Earnings per Share Performance Conditions*, 86 ACCT. REV. 703 (2011) (finding strong positive association between repurchases and EPS-contingent compensation arrangements in a sample of UK firms). *See also* source cited *supra* note 286 and accompanying text.

However, this particular function of OMRs would be less significant in the EU than in the US for various reasons. The fundamental reason for the expected insignificance would be that stock-based compensation in the EU has been less common than in the US,[514] which has been the indication of the suggestion that managers in the EU have functional rather than financial orientation. Another reason would be that periodic financial reports, which prompt managers to pay more regard to short-term performance, have historically been less frequent in the EU in comparison to the US.[515] Yet another factor would be that dividend-protected stock options, which incentivize managers to choose dividends over OMRs, have been less uncommon in the EU than in the US.[516]

On the other hand, the percentage of stock-based compensation to total compensation has increased in the EU due to the Americanization trend that has predominantly affected certain EU companies in certain EU Member States.[517] Such increase would also increase the importance of

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514 Atkins, *supra* note 215 (arguing that the immediate incentives to increase buybacks would be lower in the EU than in the US as executive remuneration is less likely to be linked to EPS—a performance measure easily manipulated by buybacks). For the comparison of the stock-based compensation of EU managers with their US counterparts, see Martin J. Conyon et al., *The Executive Compensation Controversy: A Transatlantic Analysis, in* EXECUTIVE REMUNERATION AND EMPLOYEE PERFORMANCE-RELATED PAY: A TRANSATLANTIC PERSPECTIVE 9, 11 (Tito Boeri, Claudio Lucifora & Kevin J Murphy eds., 2013) (finding that American executives hold more wealth in company stock and options than do their European counterparts, and concluding that most of the difference in cross-continental pay levels is attributable to the higher use of stock and options in the US); Kotnik et al., *supra* note 480 (finding that the percentage of stock-based compensation of managers in EU corporations are well below those that prevail in the US).

515 Notwithstanding that corporations may choose to publish financial reports more frequently than prescribed by law, public corporations in the EU are required to publish financial reports semi–annually whereas publicly traded corporations in the US are required to file their financial reports in Form 10-Q with the SEC on a quarterly basis. For a recent change on the frequency of financial reporting in the EU, see *infra* note 609. For the positive relation between repurchases and financial reporting frequency, see von Eije & Megginson, *supra* note 4, at 372 (finding that the average reporting frequency of EU companies has steadily increased over 1989–2005, from 1.2 to 2.4 times per year, and is associated with higher amounts of cash dividends paid and shares repurchased). For the positive relation between repurchases and stock options, see sources cited *infra* note 518.

516 Markus C. Arnold & Robert M. Gillenkirch, *Stock Options and Dividend Protection,* 161 J. INSTITUTIONAL AND THEORETICAL ECON. 453, 453 n.2 (2005). *See also* sources cited *infra* notes 712–13 and accompanying text.

517 Conyon et al., supra note 514, 53 tbl.2.9 (showing that, although to a lesser extent than in the US, the percentage of equity-based pay to total pay has also increased in the EU, initially in the UK and France, and later in all over

this function of OMRs and thereby the number of OMRs in the EU,[518] which is potentially driven by self-interests of managers.[519] Hence, OMRs entitle managers to stock options and stock awards while supplying shares for executive stock options and stock awards and offsetting dilution caused by stock options.[520] These multiple functions of OMRs form a spiral pattern that contributes to the increase in the number of OMRs in the EU, although to a lesser extent than in the US.

3.4 Deterring Unwanted Takeover Attempts

OMRs would inherently have the effect of deterring hostile takeover attempts for various reasons.[521] OMRs allow shareholders, who have lowest reservation values and are prone to tender their shares in a tender offer, to sell their shares back to the target company within an OMR program. Repurchasing shares from these shareholders would inflate share prices and ultimately increase the ownership percentage of management and management loyalists, who are not likely to tender their shares in a tender offer. Such increase in share price and change in ownership would increase the likelihood that the takeover attempt will fail. Moreover, squandering cash via OMRs

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Europe); Kotnik et al., *supra* note 480 (finding that the percentage of stock-based compensation of managers in EU corporations has been increasing).

[518] Young & Yang, *supra* note 513; Philipp Geiler & Luc Renneboog, *Executive Remuneration and the Payout Decision,* 24 CORP. GOVERNANCE & INT'L REV. 42 (2016) (finding that share repurchases have a positive impact on pay and CEOs adopt a payout policy that increases the value of their equity-based pay). *See also* Amadeo De Cesari & Neslihan Ozkan, *Executive Incentives and Payout Policy: Empirical Evidence from Europe,* 55 J. BANKING & FIN., June 2015, at 70 (finding that the fraction of share repurchases in total payout increases as executive stock option holdings without dividend protection increase); Natasha Burns et al., *Equity-Incentive Compensation and Payout Policy in Europe,* 30 J. CORP. FIN. 85 (2015) (finding that restricted stock and options are positively related to repurchases whereas they are negatively related to dividends).

[519] For a comprehensive analysis on the potential drawbacks arising from the combined effect of OMRs and stock-based compensation, see *infra* Part D.2.

[520] *See supra* Sections 2.3, 3.1.

[521] *See supra* Chapter II.C.4.

would also make the target company less attractive for potential bidders, who typically target cash hoarding companies.

In fact, in comparison with their counterparts in the US, EU companies have been characterized by more concentrated ownership, weaker managerial incentives, and higher debt ratios. These factors make the market for corporate control less active,[522] with fewer hostile takeover attempts.[523] On the other hand, there has been a few large previously state-run privatized EU companies, particularly in the UK. The characteristics of these companies have been similar to their counterparts in the US so that they could potentially become targets of hostile takeover attempts. In response to such potential attempts, managers of these companies may choose to execute OMRs either to force potential bidders to offer a higher price that would enable shareholders and themselves to have a higher share or to thwart potential hostile bidders in order to entrench their managerial positions.

D. Potential Drawbacks Arising from the Abuse of OMRs in the EU

OMRs could also be executed for illegitimate purposes, which could be concealed beneath legitimate purposes in the EU. This is because share repurchases led by OMRs inherently inflate share prices and EPS and inevitably distribute cash to shareholders not on a pro rata basis. Additionally, the non–obligatory nature of OMR announcements enables companies to engage in false signalling while actual OMRs enable companies to repurchase their own shares at the market

[522] Aguilera & Jackson, *supra* note 28, at 447.
[523] Marco Becht et al., *Corporate Governance and Control*, 1 HANDBOOK ECON. FIN. 1, 165 tbl.2 (2003).

price without paying any premium above the market price. For these reasons, OMRs enable those having superior information to take advantage of information asymmetry, and to obtain benefits from direct and indirect trades at the expense of less-informed shareholders. Thus, EU Member States have regarded market repurchases as potentially abusive transactions for a much longer time than the US,[524] which led the EU to prescribe a prima facie stricter regime for OMRs than the US.[525] However, since the current rule has essentially been a safe harbor rule as in the US, additional requirements have been merely conditions that companies must meet in order to benefit from the protection offered by the safe harbor rule. Consequently, the safe harbor rule, which was transcribed from the US, would also likely fail to effectively inhibit companies from executing OMRs for illegitimate purposes in the EU.

However, most EU companies traditionally do not favour OMRs—financial tools that reduce corporate capital and financially benefit managers with a view to financially benefiting shareholders by distributing cash to shareholders and mitigating agency costs. These functions fail to comply with the Continental European corporate model, in which companies are stakeholder-centered,[526] are mainly financed by banks,[527] managers tend to have functional orientation, and shareholders, as insiders, hold controlling stakes and thereby have strategic interests.[528] On the other hand, foreign active institutional shareholders have entered into the EU market and invested in a few large privatized EU companies. These shareholders facilitated these companies to largely

[524] *See supra* Part B.1–2.
[525] *See supra* Part B.5.
[526] Holder et al., *supra* note 484 (finding that corporations with stakeholder model have a lower payout ratio that enables them to make good on the implicit claims of non–investor stakeholders).
[527] Enriques & Macey, *supra* note 27, at 1198–99, 1202 (stating that legal capital rules, which limit a corporation's ability to distribute cash to shareholders and maintain corporate capital, benefit banks as risk-averse creditors).
[528] For a general overview on the Continental European corporate model and actor-centered approach to corporate models, see Aguilera & Jackson, *supra* note 28.

converge towards the Anglo-American corporate model that causes these companies to use OMRs more than other EU companies but less than their US counterparts.[529] Consequently, the potential drawbacks of OMRs that are seen in the US are also seen in the EU, although to a much lesser extent than in the US.

Managers of EU companies with more shareholder value orientation are incentivized, like their US counterparts, to increase share value in the short-term through stock-based compensation. Indeed, executive compensation in the EU has been increasingly tied to share price and EPS performance specified in periodic financial reports,[530] which could be inflated by OMRs.[531] Meanwhile, some of the foreign active institutional shareholders that have recently entered into the EU market have shorter investment horizons and actively engage in promoting shorter-term business decisions. In this context, OMRs appear as one of the financial tools that are able to inflate share prices and EPS in the short-term and satisfy interests of both managers and short-term shareholder activists. Notwithstanding that the EU acknowledged and took certain measures to

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[529] von Eije & Megginson, *supra* note 4, at 349, 360 (finding that privatized corporations account for almost one-quarter of the total value of EU cash dividends and share repurchases while representing barely 2% of the number of listed firms, and that share repurchases are even more concentrated among larger firms than are cash dividends); Sakinç, *supra* note 4, at 12–13 (arguing that large European corporations that have established similar attitudes of shareholder value orientation have been increasingly focused on corporate distributions and showing that the number of repurchases in Europe is limited compared to the US but large corporations in the EU distribute as much as US corporations on average when share repurchases and dividends are added together). More specifically see also Atkins, *supra* note 215 (arguing that one of the reasons for not expecting EU corporations to conduct buybacks as much as their US counterparts has been that activist shareholders in EU corporations are less common than those in US corporations).

[530] Kotnik et al., *supra* note 480 (finding that the percentage of stock-based compensation of managers in EU corporations has been increasing and documenting the heterogeneity among countries, with the largest proportion of stock-based compensation in France and the UK where the majority of total compensation is stock-based).

[531] Geiler & Renneboog, *supra* note 518 (finding that share repurchases have a positive impact on pay and CEOs adopt a payout policy that increases the value of their equity-based pay).

inhibit short-termism lately,[532] the potential alignment of interests of managers and short-term shareholder activists with respect to OMRs might still cause companies to excessively execute OMRs, although to a lesser extent than the US, that might harm companies and their stakeholders having long-term interests.[533]

Hence, in order to compare the potential drawbacks of OMRs in the EU with that of the US and analyze to what extent these drawbacks may occur, the following analysis comprises two sections. The first section examines how and to what extent corporate actors having superior information are able to exploit OMRs in the EU in comparison with the US. The second section will turn its attention to the potential alignment of interests between managers and short-term shareholder activists and analyzes how and to what extent such alignment might result in OMR-induced underinvestment that would ultimately harm companies, corporate stakeholders and the economy as a whole.

1. Market Manipulation and Informed Trading via OMRs

OMRs, like all repurchasing methods, are inflationary and disproportionate in nature. Additionally, OMR announcements have a non–obligatory nature that enables companies to engage in false signalling and actual OMRs have a bargain nature that enables companies to repurchase their

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[532] More recently, the EU policymakers, who have become concerned about the increasing short-term thinking, amended certain directives to encourage institutional shareholders having longer-term interests to more actively exercise their rights and to engage with the company; to decrease the frequency of financial reporting by replacing the quarterly reporting requirement with semi–annual and annual earnings reports. For further information on these amendments, *see infra* notes 608–09 and accompanying text.

[533] Sakinç, *supra* note 4 (arguing that the increasing value extraction in Europe in the form of corporate payouts comes at the expense of investment in productive resources and employment opportunities).

undervalued shares at the market price without paying any premium above the market price. The execution of these potentially manipulative transactions is inherently left to the discretion of managers, who have access to inside information.[534] Subject to certain securities law limitations,[535] managers can also trade on their own shares and exercise their stock options around OMR-related actions. The combination of the potentially manipulative nature of OMRs with the broad managerial authority enables managers to take advantage of inside information and obtain benefits from direct and indirect trades at the expense of less-informed shareholders. The ability of managers to exploit OMRs has also been recognized by the EU. However, the EU relaxed the regime on share repurchases, and particularly OMRs, and adopted the regulatory method that is nearly identical to that in the US,[536] which has been ineffective in inhibiting managers from engaging in manipulation and insider trading via OMRs.[537]

Unlike in the US where the authorization for executing OMRs is given to managers by directors, such authorization must be given to managers by shareholders at the general meeting in the EU.[538] This difference has been mainly due to the difference between ownership structures of companies in the EU and the US. Unlike in the US, ownership of most EU companies has been concentrated in the hands of large shareholders having control over companies. These controlling shareholders would typically have access to inside information and be subject to the insider trading rule. On the other hand, there have recently been certain active institutional shareholders that typically hold

[534] Directive 2017/1132, *supra* note 429, art. 60(1)(a), at 75.

[535] Unlike in the US, a blackout period during which insiders are prohibited from trading their own shares is prescribed in the EU. *See* Article 19(11) of the MAR.

[536] *See* Directive 2017/1132, *supra* note 429, art. 60, at 75–76; Market Abuse Regulation 596/2014, *supra* note 447, art. 5, at 22–23; Commission Delegated Regulation 2016/1052, *supra* note 67, arts. 2–4, at 36–38.

[537] *See supra* Chapter II.D.1.1.

[538] Directive 2017/1132, *supra* note 429, art. 60(1)(a), at 75.

minority stakes but still have access to superior (not inside) information that some other shareholders would not have and are able to trade on superior information. Thus, the fact that OMRs distribute cash to shareholders disproportionately, unlike dividends, would allow those having superior information to use their informational advantage to exploit OMRs at the expense of less-informed shareholders.

Hence, this section consists of two subsections. The first subsection reviews whether, how and to what extent managers are able to engage in market manipulation and insider trading via OMRs for their self-interests in the EU. The second subsection examines whether, how and to what extent active institutional shareholders in the EU are able to exploit OMRs by adjusting their trading decisions based on superior information they possess and harm less-informed shareholders and ultimately markets.

1.1 Managers' Ability to Exploit OMRs in the EU

Managers of EU companies have the sole authority to execute OMRs, like their counterparts in the US. However, unlike in the US, the authorization to execute OMRs must be given to managers by shareholders in the EU.[539] This authorization process requires an additional preliminary announcement, namely the initial statement of intention to obtain the shareholders' authorization for a share repurchase program. Moreover, in order for repurchasing companies to benefit from the protection offered by the safe harbor rule, the EU requires companies to publicly disclose

[539] *Id.*

details of each OMR program prior to actual OMR activity.[540] Ultimately, the EU also requires companies to report and publicly disclose each OMR activity after-the-fact.[541] While these informative corporate disclosures regarding OMRs potentially have inflationary effect on share prices, actual OMRs certainly inflate share prices.[542] Hence, the inflationary effect of both OMR announcements and actual OMRs enable managers, who possess inside information regarding the execution of OMRs as well as other non–public corporate information, to use such information to exploit OMRs through adjusting their own investment decisions. That is, managers may buy shares at a discount prior to OMR-related corporate actions and sell shares or exercise their stock options at a premium following OMR-related corporate actions.

Managers are also able to exploit actual OMRs via indirect insider trading; namely, managers, instead of trading in their own shares, have companies to buy shares that are perceived to be undervalued.[543] This is because actual OMRs enable companies to repurchase their undervalued shares at the market price without paying any premium above the market price. Moreover, irrespective of whether shares are undervalued, the inflationary effect of actual OMRs on share prices and EPS bolsters executive compensation, a portion of which consists of stock-based pay that is tied to these metrics in the EU as well.[544] Consequently, the bargain and inflationary nature of actual OMRs, when combined with their disproportionate nature, enable managers of EU companies to exploit actual OMRs without trading in their own shares. Instead, managers may

[540] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(a), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.
[541] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(b), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(2)–(3), at 37.
[542] *See infra* Paragraph 1.1.1.
[543] *See infra* Paragraph 1.1.2.
[544] *See* sources cited *supra* notes 513, 517 and accompanying text.

benefit from OMRs by having a company repurchase its own shares when managers retain their own shares and enrich themselves at the expense of less-informed shareholders that are on the sell-side.

Therefore, this subsection consists of two paragraphs. The first paragraph explains instances in which managers are able to engage in direct insider trading via preliminary OMR-related corporate actions and actual OMRs, and whether and to what extent they do so in comparison to their counterparts in the US. The second paragraph explains the process through which managers are able to exploit actual OMRs without trading on their own shares, and whether and to what extent they engage in indirect insider trading via OMRs when compared to their US counterparts.

1.1.1 Insider Trading Around OMR Announcements and Actual OMRs

OMRs in the EU have been subject to a more rigorous disclosure regime than in the US. First, unlike in the US, shareholders authorize managers to execute OMRs in the EU,[545] and vesting authorization power to shareholders requires a preliminary corporate action. This authorization procedure requires a statement of intention of the board to obtain authorization from shareholders as well as the announcement of the authorization itself. Second, in addition to the reporting and disclosure requirements after the completion of OMRs that have been mandatory,[546] the EU requires companies to disclose details of each OMR program prior to the start of trading in order

[545] Directive 2017/1132, *supra* note 429, art. 60(1)(a), at 75.
[546] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(b), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(2)–(3), at 37.

to benefit from the exemption provided by the safe harbor rule.[547]

Each OMR-related corporate disclosure has information content and potentially gets positive market reaction and increases share prices.[548] However, the "pre–repurchase disclosure requirement" signals more credible information that has been shown to cause a higher increase in market reaction and thereby share price in the EU in comparison to the US.[549] Such increases in share price would provide larger price spread for managers to exploit OMRs. Yet, managers have superior information regarding these disclosures as well as other firm-specific factors affecting the level of increase on share price. They are also able to trade their shares and exercise their stock options; namely, to purchase shares at a discount prior to these corporate disclosures and/or (exercise stock options and) sell shares at a premium afterwards. Hence, these preliminary OMR-related corporate disclosures would create the risk for market manipulation and insider trading.

These preliminary OMR-related corporate disclosures (including the pre–repurchase disclosure requirement) do not oblige companies to actually execute OMRs. Nevertheless, markets tend to react positively to these actions and share prices increase even if companies choose not to actually repurchase their own shares. However, there might be instances when markets underreact to these

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[547] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(a), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.

[548] Andriosopoulos & Lasfer, *supra* note 469 (arguing that each OMR-related corporate disclosure has information content, whereas the initial statement of intention to obtain authorization conveys greater information than recurring announcements but the announcement date market reaction to initial announcements in the EU has been lower than that in the US).

[549] Hackethal & Zdantchouk, *supra* note 497 (measuring abnormal price effects around both initial statements to establish a repurchase plan and actual repurchase announcement, finding that total abnormal returns around these announcements are four times higher than those reported for OMR announcements in the US, and explaining the discrepancy in average announcement effects with differences in OMR regulations that make the law in Germany stricter and thereby more credible than the OMR regulation in the US).

corporate disclosures. In these cases, managers are likely to actually execute OMRs. Actual OMRs increase marginal price by allowing companies, if stock demand curves are downward-sloping, to repurchase their own shares at a discount from shareholders, whose share valuation is lower.[550]

Managers are also able to make voluntary disclosures and manipulate information flows by making bad news announcements before actual OMRs and good news announcements after actual OMRs in order to increase the price spread before and after actual OMRs.[551] The increased price spread before and after actual OMRs makes actual OMRs susceptible to market manipulation and insider trading as well. Yet, managers, to whom the authority to execute OMRs has been allocated, decide when to execute OMRs and are free to engage in insider trading; namely, to purchase shares at a discount prior to actual OMRs and/or exercise stock options and sell shares at a premium after actual OMRs.

In the face of the potential risk of market manipulation and insider trading via OMRs, the EU regulates OMRs with a safe harbor rule that is similar to that in the US. Having said that, the EU version prescribes a more detailed and timelier disclosure regime than that in the US and imposes additional trading conditions and restrictions that are absent in the US. However, since the rule has essentially been a safe harbor rule, these additional disclosure requirements and trading conditions and restrictions have all been preconditions for companies to benefit from the safe harbor

[550] Stout, *supra* note 158, at 489–90.

[551] For statistical evidence on the practice of releasing good news announcements after the execution of actual OMRs, see Edith Ginglinger & Jacques Hamon, *Share Repurchase Regulations: Do Firms Play by the Rules?*, 29 INT'L REV. L. & ECON. 81 (2009) (documenting that illegal repurchases before earnings announcements are the most detrimental to selling shareholders). For a concrete example of such practice, see *also infra* note 561.

protection against prohibitions of manipulation and insider trading provisions.[552] Thus, the noncompliance to the rule would result in trades made on that trading day to fall outside the scope of the protection of the safe harbor rule, but would not directly be deemed to constitute market abuse.[553]

Moreover, the safe harbor rule is not directly enforceable. In order for an OMR activity to constitute market abuse, private plaintiffs and/or market authorities must enforce anti–manipulation provisions and the insider trading rule against insiders. However, private enforcement against OMRs seems unlikely in the EU, like in the US. This is because shareholders are unlikely to bring legal actions against insiders for executing OMRs that usually have a positive impact on share prices and EPS. Moreover, the probability of private enforcement against OMRs in the EU would be expected to be much lower than the US. Yet, certain procedural incentives including but not limited to class actions, contingency fees, effective discovery obligations, and the provision prohibiting short swing profits of insiders that are available in the US have been absent in the EU.[554] As a matter of fact, the lag in private enforcement has been mainly due to the Continental European corporate model, in which ownership has been concentrated in the hands of controlling shareholders.[555] Controlling shareholders, as potential suitors, hold larger stakes, have

[552] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)–(3), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, Recital (1) & art. 2(1), at 34, 36–37.
[553] Market Abuse Regulation 596/2014, *supra* note 447, Recital (12), at 3.
[554] Marco Ventoruzzo, *Comparing Insider Trading in the United States and in the European Union: History and Recent Developments*, 11 EUR. COMPANY & FIN. L. REV. 554, 591–92 (2014).
[555] John C. Coffee Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 309 (2007) (agreeing with the hypothesis that enforcement intensity has been the result (not the cause) of the level of retail ownership).

a strong influence on management and prevent managers from executing OMRs (and engaging in insider trading) at the outset.[556]

On the other hand, the European approach on insider trading is claimed to be broader than the American approach.[557] Yet, insider trading law in the US, through case law, abandoned the equal access to information theory in favor of the classical theory of insider trading—extended by the misappropriation theory—that requires defendants to breach a fiduciary duty owed to the other party of the transaction to incur in liability for insider trading.[558] On the other hand, the MAR in the EU identifies primary insiders on the basis of their ability to access to inside information and constructs that any person, who possesses inside information and knows or ought to know that it is inside information, is insider.[559] The broader approach is expected to increase the probability of public enforcement and thereby reduce the possibility of committing insider trading. However, the effectiveness of enforcement of market abuse law in the EU has been similar to that in the US once the number of actions are adjusted for the number of reporting corporations and the market capitalization.[560] Indeed, similar to the US where there has been no OMR-related legal actions,

[556] von Eije & Megginson, *supra* note 4, at 352 (finding that corporations that have a majority shareholder repurchase less).
[557] Ventoruzzo, *supra* note 554, at 571–73, 588–92 (arguing that the EU has a broader approach because the EU insider trading law is based on the equal access to information theory whereas the American approach is largely based on the violation of a fiduciary duty. The author also emphasises that, as a reflection of the broader approach, the EU requires corporations to disclose all material information with a substantive rule, while the Exchange Act in the US does not provide for a general duty to disclose all material information, though corporations have specific disclosure obligations pursuant to Section 13 of the Securities Exchange Act of 1934, namely annual reports on Form 10-K, quarterly reports on Form 10-Q, and any updates to these periodic reports as well as prompt disclosure of identified events that may be of significance to shareholders on Form 8-K).
[558] *Id.*
[559] Market Abuse Regulation Art. 8(4).
[560] *See* Ventoruzzo, *supra* note 554; Coffee, *supra* note 555.

there has been only one OMR-related insider trading case in the EU.[561] This has been the case despite the evidence suggesting that the vast majority of companies fail to comply with the trading conditions and restrictions prescribed by the safe harbor rule.[562]

The lack of OMR-related public enforcement in the EU might also be attributed to the persistence of the Continental European corporate model for the majority of EU companies. In this model, managers have functional orientation rather than financial orientation and thereby do not attach much importance to financial tools like OMRs that artificially increase share prices and EPS as much as their US counterparts.[563] As a result, even though the EU has largely adopted the ineffective regulatory framework of the US with respect to OMRs that has a similar outcome, the lack of OMR-related public enforcement in the EU seems less implausible since the risk of exploitation of OMRs by managers of EU companies is likely to be lower owing to the underlying corporate model in the EU.

[561] Case C-45/08, Spector Photo Group NV and Chris van Raemdonck v. Commissie voor het Bank-, Financie- en Assurantiewezen (CBFA), 2009 E.C.R. I-12073. The corporation in question purchased its own shares on the market to implement a stock option program for employees and subsequently published new and positive results concerning its commercial policy, which increased the share price. The case came up before the European Court of Justice after the decision was appealed, in which the Belgian national authority regarded the two purchases as insider dealing and fined both the corporation and one of its managers, who placed the purchase orders. The European Court of Justice held that an insider is presumed to have committed insider trading if an insider possesses inside information and uses it in trading shares that are related to the inside information, and the insider must rebut that presumption. However, the European Court of Justice left the final decision to the national courts.

[562] Ginglinger & Hamon, *supra* note 551 (finding that very few firms fully comply with the regulations for all their buybacks, with 79% of firms violate these restrictions in at least one trading day based on the data of OMRs made by French firms over the period 2000–2002). It should be noted that the cited study covers the period before the adoption of the MAD. For a comparison of the old regulation in France with the regulation prescribed by the MAD and their impact on OMR activity, see Siems & De Cesari, *supra* note 422.

[563] Aguilera & Jackson, *supra* note 28, at 457–59. More specifically, see sources cited *supra* note 514 and accompanying text.

1.1.2 Indirect Insider Trading via Actual OMRs

Managers in the EU may also theoretically benefit from actual OMRs even when they choose not to trade their own shares.[564] Yet OMRs, in comparison to other repurchasing methods, enable companies to repurchase their undervalued shares at the market price that are typically cheaper than those repurchased at a premium over the market price.[565] On the other hand, actual OMRs (as well as ex post announcements of OMR data and voluntary good news announcements following actual OMRs) inflate share prices.[566] In this context, repurchasing undervalued shares via actual OMRs would benefit non–selling shareholders at the expense of selling shareholders.[567] Consequently, managers, who have private information indicating that shares are undervalued, may execute OMRs, retain their own shares, and reap gains via actual OMRs at the expense of less-informed shareholders, who choose to tender their shares within an OMR program.

If shares are undervalued, managers, as rational investors, are expected to purchase undervalued shares with their own wealth. This is because direct insider trading would be more lucrative than indirect insider trading. However, managers may still choose to engage in indirect insider trading by having companies purchase undervalued shares via OMRs for various reasons.[568] First, managers might have liquidity constraints that would inhibit them to exploit OMRs by trading on their own shares.[569] Second, insider trading laws, though not effectively enforceable in the case of

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[564] *See supra* note 280 and accompanying text.
[565] Grullon & Ikenberry, *supra* note 40, at 33–34.
[566] *See supra* notes 550–51 and accompanying text.
[567] *See supra* note 282 and accompanying text.
[568] Fried, *supra* note 43, at 1346.
[569] *Id.*

OMRs, might deter managers from engaging in direct insider trading.[570] Third, the MAR in the EU requires insiders to disclose their trades immediately and no later than three business days after the date of the transaction.[571] Lastly, the MAR also prohibits insiders from dealing in securities during specific times throughout the year before the announcement of financial reports.[572]

On the other hand, there have also been a number of factors that make it hard for managers in the EU to engage in indirect insider trading, like in the US.[573] Moreover, there have been additional legal factors that make it more difficult for managers to engage in indirect insider trading in the EU than in the US. First, managers would hesitate to engage in indirect insider trading more than their US counterparts because the EU prescribes more detailed and timelier post–repurchase disclosure and reporting requirements than those in the US, which theoretically enable private plaintiffs and/or market authorities to more easily detect indirect insider trading.[574] Second, even if indirect insider trading goes undetected, the pre–repurchase disclosure requirement is likely to inflate share prices that would make OMRs costly for companies. [575] Thus, OMRs would economically be unproductive for non–selling shareholders including managers, who would want to retain their shares and reap personal gains via indirect insider trading. However, it should also

[570] It should also be noted that the short-swing profit statute under the Section 16(b) of the Securities Exchange Act of 1934 in the US, which prohibits managers from buying and selling or selling and buying shares within a six-month period when the purchase price is lower than the sales price, is absent in the EU. *See* Ventoruzzo, *supra* note 554, at 589. For further information on the impact of the short-swing profit statute on the propensity of managers to engage in indirect insider trading via OMRs, see *supra* note 289 and accompanying text.
[571] Market Abuse Regulation 596/2014, *supra* note 447, art. 19(1), at 38.
[572] *Id.* art. 19(11), at 40.
[573] Fried, *supra* note 43, at 1347 (claiming that corporations may also face liquidity constraints and managers may not always have private information indicating that shares are undervalued or be reluctant to repurchase shares when they think they possess clearly material non-public information).
[574] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(2)–(3), at 37.
[575] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37. For the inflationary effect of pre–repurchase disclosures on share prices, see *supra* note 497 and accompanying text.

be noted that the pre–repurchase disclosure requirement has not been mandatory, but has been merely one of the conditions for companies to benefit from the exemption provided by the safe harbor rule.[576]

The inflationary effect of pre–repurchase disclosure requirement on share prices might result in companies repurchasing overvalued shares that would transfer value from non–selling to selling shareholders. Even in such cases, managers may reap gains if a fraction of their compensation comprises of stock-based pay.[577] Managers, whose compensation has been conditioned to certain share price and EPS levels, tend to execute OMRs in order to inflate share prices and EPS to the levels that are set for managers to be entitled to their stock options and stock awards.[578] Notwithstanding that the stock-based pay in the EU increases due to the Americanization trend, stock-based pay still comprises a smaller portion of executive compensation than their counterparts in the US.[579] Moreover, dividend-protected stock options, which would incentivize managers to prefer dividends instead of OMRs by shielding their stock options from share price decreases following dividend payments, have been less uncommon in the EU than in the US.[580] Consequently, all these EU-specific factors would cause managers to engage in indirect insider trading via OMRs much less than their counterparts in the US.

[576] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(a), at 22; Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.
[577] *See* sources cited *supra* note 285 and accompanying text.
[578] Young & Yang, *supra* note 513; Geiler & Renneboog, *supra* note 518.
[579] Kotnik et al., *supra* note 480, at 14, 22–23 (comparing the compensation data for the 299 CEOs of S&P 350 corporations from 11 European countries with the data for the 500 CEOs of S&P 500 corporations in the US in 2015, and finding that 76 percent of the total compensation consists of actual realized gains from stock-based pay in the US, whereas stock-based pay accounts for 49 percent of the total compensation in the EU, with the majority of total compensation is stock-based only in the UK, Ireland, and France).
[580] *See* sources cited *infra* note 712–64 and accompanying text.

1.2 Active Institutional Shareholders' Ability to Exploit OMRs

Continental European corporate model characterizes most EU companies, in which ownership is concentrated in the hands of a few shareholders such as families, banks, other firms, and/or state.[581] These shareholders hold large stakes and have control over management so that agency costs do not typically incur between managers and shareholders. Instead, agency costs potentially arise between controlling shareholders and minority shareholders.[582] Controlling shareholders typically make relational investing and pursue strategic interests, whereas minority shareholder usually as pursue financial interests.[583] Thus, controlling shareholders seek to wield power and reduce ownership percentage of minority shareholders in various ways, one of which has been OMRs.[584] That is, controlling shareholders of EU companies would not exploit OMRs in the same way as they are exploited in the US. Moreover, controlling shareholders would be under scrutiny in terms of anti–manipulation and insider trading rules, which would deter them from engaging in financial activities to the detriment of minority shareholders.[585] Thus, controlling shareholders continue to

[581] Aguilera & Jackson, *supra* note 28, at 448, 453.

[582] Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 758–59 (1997) (arguing that, in controlled corporations, agency costs are incurred between minority and controlling shareholders that exercise complete control over the managers).

[583] Aguilera & Jackson, *supra* note 28, at 450–54.

[584] Edith Ginglinger & Jean-François L'her, *Ownership Structure and Open Market Stock Repurchases in France*, 12 EUR. J. FIN. 77, 80 (2006) (claiming that share buybacks are likely to reinforce the power of controlling shareholders based on the assumption that controlling shareholders will not tender their shares so that their ownership percentage would increase and ownership would become more concentrated, which would make minority shareholders much weaker and also reduce the likelihood of a takeover and decrease firm value).

[585] Luc Renneboog & Grzegorz Trojanowski, *Patterns in Payout Policy and Payout Channel Choice*, 35 J. BANKING & FIN. 1477 (2011) (stating the insider trading regulation as one of the factors that may adversely affect the attractiveness of share repurchases as opposed to dividends for large shareholders).

prefer dividends over OMRs as the main method of cash distribution[586]—a sign indicating that they do not tend to financially exploit OMRs.

On the other hand, a few large EU companies have relatively dispersed ownership in that these companies were privatized by going public so that individual shareholders and foreign institutional shareholders, particularly hedge funds, were also able to invest in these companies.[587] The co–existence of foreign institutional shareholders and controlling shareholders would typically incur agency costs because foreign institutional shareholders and controlling shareholders have divergent interests. More specifically, while controlling shareholders have strategic interests, foreign institutional shareholders, who typically hold minority stakes, have financial interests and thereby favour shareholder payouts including OMRs.[588] Indeed, evidence suggests that the large privatized EU companies, which have received investments from foreign institutional shareholders, distribute cash to shareholders and use OMRs more than other EU companies.[589]

In parallel to the increasing demand for OMRs, EU Member States initially (de)regulated OMRs as part of the liberalization policy that involves the deregulation of company laws through the adoption of more flexible alternatives that would conform with different corporate governance models.[590] The liberalization efforts of EU Member States were followed by the harmonization

[586] *Id.* (documenting that firms with concentrated ownership tend to opt for dividends rather than share repurchases, irrespectively of the identity of the controlling shareholder. *See also* von Eije & Megginson, *supra* note 4, at 369, 371 (finding that EU corporations with concentrated ownership (with one majority shareholder) repurchase even less than large privatized corporations with relatively more dispersed ownership that also prefer dividends over repurchases).
[587] *See supra* Part B.3.
[588] Ginglinger & L'her, *supra* note 584, at 92 (claiming that foreign investors are presumably petitioning for such value-added structures as open market repurchase programs).
[589] von Eije & Megginson, *supra* note 4, at 357.
[590] *See supra* Part B.3.

efforts of the EU, pursuant to which a series of directives have been adopted.[591] As examined in detail above, one of these directives was the MAD, which was later transformed into the MAR, that (de)regulated OMRs by adopting the safe harbor rule that allow EU companies to more easily execute OMRs.[592] Other directives mainly sought to extend minority shareholders' rights that primarily enabled foreign institutional shareholders to more actively monitor EU companies. On the other hand, the MAR in the EU, unlike its US counterpart, extends the prohibition on insider trading in a way to include anyone who possesses inside information while that person knows, or ought to have known, that it is inside information.[593]

As a matter of fact, active institutional shareholders, particularly hedge funds, would likely have superior information rather than inside information in the EU context.[594] In other words, active institutional shareholders inherently have informational advantage over less-informed shareholders owing to funds and expertise they have.[595] Moreover, shareholder rights were extended, particularly through the recognition of proxy voting and proxy advisory firms. Such recognition enabled active institutional shareholders to acquire information by outsourcing research and/or voting decisions to proxy advisory firms. Proxy advisory firms establish dialogue with managers and retrieve corporate information and inform their clients and advise them on how to cast their votes.[596] Consequently, active institutional shareholders, though typically holding

[591] *See supra* note 436.
[592] Market Abuse Directive 2003/6, *supra* note 435, art. 8, at 23; Market Abuse Regulation 596/2014, *supra* note 447, art. 5(1)(a), at 22.
[593] Market Abuse Regulation 596/2014, *supra* note 447, art. 8(4), at 26.
[594] *See supra* Chapter II.D.1.2.
[595] *Id.*
[596] Directive 2007/36/EC, of the European Parliament and of the Council of 11 July 2007 on the Exercise of Certain Rights of Shareholders in Listed Companies, Recital (10) & art. 10, 2007 O.J. (L 184) 17, 18, 22–23. Proxy advisory firms support hedge fund activism and give voting recommendations to other institutional shareholders to align with hedge funds, whereas they also push for certain corporate practices that would strengthen the presence of hedge funds

minority stakes, would have superior information that enable them to adjust their trades and exploit OMRs at the expense of less-informed shareholders in the EU, like in the US.

2. Adverse Consequences of Excessive Use of OMRs due to Aligned Interests

Active foreign institutional shareholders that have recently invested in EU companies typically have financial interests and prefer companies to distribute cash to shareholders. Some of these shareholders, particularly hedge funds, also tend to actively engage in corporate governance and put pressure on the management to pursue riskier policies that would meet high return expectations of their sophisticated investors. Hedge funds are able to put such pressure despite typically holding minority stakes. This is because regulatory changes in the EU, which extended shareholder rights and relaxed certain rules that allowed hedge funds to employ their investment strategies, have enabled hedge funds to engage in activism.[597] The increased activism would also cause certain hedge funds to have shorter investment horizons. Thus, hedge funds would pressure management to pursue policies that inflate share prices in the short-term, one of which has been OMRs, even if such policies would have the effect of reducing long-term investments and come at the expense of long-term interests of companies.[598] Consequently, short-term shareholder activists are able to

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in their relationship with managers by giving them opportunities to have a say on executive pay and more easily replace managers. For further information on the importance of the role of proxy advisory firms in European markets, see Joerg-Marcus Hitz & Nico Lehmann, *Empirical Evidence on the Role of Proxy Advisors in European Capital Markets*, 27 EUR. ACCT. REV. 713 (2018).

[597] Wolfgang Bessler et al., *The Returns to Hedge Fund Activism in Germany*, 21 EUR. FIN. MGMT. 106 (2015) (arguing that hedge funds took advantage of control gap that occurred due to recent regulatory changes in the German financial system and acquired stakes in weakly governed and less profitable firms, and they join forces to form an implicit alliance that gives them a sufficiently large number of voting rights to influence or force key decisions, and their activism increases, on average, shareholder value in the short- and long-run). *See also* sources cited *supra* note 423.

[598] *Id.* (making a distinction between hedge funds and arguing that aggressive hedge funds publicly attack target management and generate temporary increases in share prices in the short-term and attempt to expropriate shareholders and debtholders of target corporations by exiting at temporarily increased share prices).

exert pressure on management to distribute cash to shareholders particularly in the form of OMRs for their short-term interests irrespective of the long-term consequences of OMRs on companies and their stakeholders having long-term interests.

In order to align interests of managers with those of shareholders in companies with active institutional ownership, managers have been incentivized through stock-based compensation that ties executive compensation to the share price and EPS performance of companies,[599] which could be inflated by OMRs.[600] The share price and EPS levels to be reached used to be specified mainly in quarterly earnings reports—the reports the EU had recommended EU Member States to require companies to file in order to promote more transparency particularly for minority shareholders.[601] These short-term targets induced managers to execute OMRs to inflate share prices and EPS in the short-term.[602] By adopting policies to increase share value in the short-term, managers would also attract active institutional shareholders with short-term interests to invest in their company and gain reputation of shareholder value maximizers. Owing to this reputation, managers would find

[599] Kotnik et al., *supra* note 480 (finding that the percentage of stock-based compensation of managers in EU corporations has been increasing and documenting the heterogeneity among countries, with the largest proportion of stock-based compensation in France and the UK where the majority of total compensation is stock-based); Ettore Croci et al., *CEO Compensation, Family Control, and Institutional Investors in Continental Europe,* 36 J. BANKING & FIN. 3318 (2012) (finding that family control curbs the fraction of equity-based CEO compensation indicating that controlling families do not use CEO compensation to expropriate wealth from minority shareholders, whereas institutional ownership, particularly the presence of foreign institutional investors, is associated with higher levels of CEO compensation in Continental Europe).

[600] For the positive relation between repurchases and EPS-contingent compensation arrangements in the UK, see Young & Yang, *supra* note 513.

[601] Directive 2004/109/EC, of the European Parliament and of the Council of 15 Dec. 2004 on the Harmonisation of Transparency Requirements in relation to Information about Issuers whose Securities are Admitted to Trading on a Regulated Market and Amending Directive 2001/34/EC, 2004 O.J. (L 390) 38. The Directive recommended EU Member States to require corporations to report financial statements on a quarterly basis. For the impact of this policy recommendation on the financial reporting frequency as well as the positive correlation between the financial reporting frequency and the number of dividends and repurchases by EU corporations, see *supra* note 514.

[602] Geiler & Renneboog, *supra* note 518.

managerial jobs once they leave companies with hefty compensation schemes before long-term consequences of short-term policies ensue. Consequently, interests of managers and short-term shareholder activists seem to have aligned with respect to OMRs in EU companies having the Anglo-American corporate model.

The alignment of short-term interests between managers and short-term shareholder activists with respect to OMRs would likely cause excessive quantities of corporate cash being spent on OMRs. Squandering cash via OMRs instead of making new investments might lead to underinvestment and undermine the corporate sustainability.[603] Indeed, in parallel with the change in ownership structures and corporate governance practices in large EU companies, shareholder payouts have increased.[604] On the other hand, investment has decreased and employment has modestly grown despite the continuing consolidation of industries.[605] Such consolidation occurred through mergers and acquisitions that have shaped large companies in the EU,[606] which largely follow the shareholder-oriented corporate model that prioritizes the maximization of shareholder value.

Moreover, as noted above, harmonization efforts in the EU had resulted in the liberalization of the company law directive and thereby the legal capital regime in the EU.[607] In this context, share repurchases, as one of the distribution methods that have been an integral part of this regime, have been subject to a more relaxed rule since 2006. For instance, the rule formerly mandated EU Member States to restrict companies from acquiring more than 10% of the subscribed capital

[603] Sakinç, *supra* note 4, at 19.
[604] *Id.*
[605] *Id.*
[606] *Id.*
[607] *See infra* Part B.4.

(authorized capital) has now become advisory. However, most EU Member States continue to strictly regulate the amount to be repurchased by companies.

Moreover, the EU policymakers have become concerned about the increasing short-term thinking, which includes the increase in the use of OMRs, to the detriment of companies and their stakeholders having long-term interests. Thus, some of the EU directives, which were adopted as part of the harmonization efforts of the liberalized national laws in the 2000s, have been amended. Accordingly, the lack of engagement of institutional shareholders having longer-term interests, particularly insurance companies and pension funds, was identified as one of the main causes of the rise of the short-term thinking. Thus, the Directive 2007/36/EC, which is colloquially known as Shareholder Rights Directive, was amended to encourage institutional shareholders having longer-term interests to more actively engage in corporate governance by voting their shares, including approval of executive compensation.[608] Moreover, Directive 2004/109/EC, which is colloquially known as the Transparency Directive, was reviewed due to the concerns that quarterly financial statements have contributed to the short-term thinking of managers and this requirement was largely replaced with semi–annual and annual earnings reports.[609] While the impact of these

[608] Directive (EU) 2017/828, of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132) 1. The Directive instructs EU Member States to require corporations to seek shareholder approval for certain transactions including their policy on directors' remuneration, improve the ability of shareholders to communicate with the corporation and exercise their votes through intermediaries, and require proxy advisory firms to improve the quality of their recommendations to institutional shareholders.

[609] Directive 2013/50/EU, of the European Parliament and of the Council of 22 Oct. 2013 Amending Directive 2004/109/EC of the European Parliament and of the Council on the Harmonisation of Transparency Requirements in relation to Information about Issuers whose Securities are Admitted to Trading on a Regulated Market, Recital (4), 2013 O.J. (L 294) 13, 13. The Directive instructs EU Member States to abolish interim management statements and quarterly financial reports, and instead require corporations to publish financial reports no more frequent than annually and semi–annually since frequent reporting represents an important burden for many small and medium-sized issuers, is unnecessary for investor protection, and above all, encourages short-term performance and discourages long-term investment that is essential for sustainable value creation and long-term oriented investment strategy. Hence,

changes on the short-term thinking in the European corporate landscape has yet to be seen, the EU at least acknowledged the potential adverse consequences of short-termism, one of the tools of which has been OMRs. Consequently, the stance against short-termism in the EU might also curb OMR activity and mitigate the adverse consequences of excessive OMR activity on companies and their stakeholders.

E. Interim Conclusion

This chapter has contrasted the regulation on OMRs and the purported benefits of OMRs and potential drawbacks arising from the abuse of OMRs in the US with those in the EU, which is composed of member states that have economic and corporate model that substantially differ from those in the US. This chapter has demonstrated that the fundamental differences between the US and the EU had also been reflected in regulation of share repurchases, which were restricted under the legal capital regime prescribed by the Second Company Law Directive in the EU, unlike in the US. The rule on share repurchases contained in the Second Company Law Directive was influenced by a decision given by a British court. This is interesting in that the UK, though categorized as having an Anglo-American economic and corporate model, had taken the prohibitive approach to share repurchases that have actually been beneficial financial tools in the Anglo-American economic and corporate setting. The UK approach to share repurchases was welcomed by the rest of the EU that typically has Continental European economic and corporate model, in which share repurchases were not much needed, and thereby strictly regulated.

abolishing more frequent reporting requirements would be expected to reduce short-term pressure on issuers and give investors an incentive to adopt a longer-term vision.

However, this chapter has also demonstrated that national rules on share repurchases and OMRs in the UK and later in Continental Europe have converged towards the American Rule. Global competitive pressures forced EU Member States, particularly the UK in the 1980s and the rest of Europe in the 1990s, to revise their economic and corporate model and liberalize its rules and regulations in line with those in the US. This is because the US economic and corporate model was widely claimed to be superior at the time. As part of the liberalization process, national rules governing share repurchases and OMRs have been deregulated in EU Member States. Following the deregulation of national laws on OMRs, the EU sought to harmonize these national rules and regulations in the 2000s. To this end, the EU relaxed the legal capital rule that includes the general rule on share repurchases, and above all, (de)regulated OMRs by adopting a safe harbor rule, like in the US. Thus, this chapter has contributed to the convergence debate in that the OMR regulation in the EU has substantially converged towards the regulation in the US, except for a few regulatory technical differences that arise from larger institutional differences between the US and the EU.

One of the few regulatory technical differences between the OMR rules of the EU and the US has been that the OMR rule in the EU requires companies to execute OMRs only for one of the purposes exclusively specified in the rule and publicly disclose for what purpose they execute OMRs as a precondition to benefit from the protection offered by the safe harbor rule. These purposes have been customized to the potential needs of EU companies. Accordingly, one purpose for OMRs would be to reduce capital since legal capital regime and the minimum capital requirement have still been relevant concepts in the EU. The second purpose for OMRs would be to supply shares for debt financial instruments that are exchangeable into equity instruments that are used by holding companies and state-owned enterprises. Another legitimate purpose for executing OMRs, again as a reflection of the Americanization trend, would be to supply shares for share option programs to employees or executives of a company or of an associate company.

However, this chapter has argued that EU companies could also execute OMRs for purposes other than those stated in the rule and conceal their actual purpose(s) with one of the purposes stated in the rule. Even if companies do not attempt to conceal their actual purpose, the mere consequence of executing OMRs for purposes that are not specified in the rule would be that all the repurchasing transactions will be removed from the safe harbor for that day. Thus this chapter has claimed that the EU, by adopting the non-exclusive safe harbor rule, largely neutralizes the potential filtration effect of technical differences and prescribes a regulatory regime that is almost as ineffective as in the US. Indeed, following the adoption of safe harbor rules both at the state and the federal level, the number of OMRs has increased in the EU even at a higher pace than in the US. However, this chapter has also found that the potential functions of OMRs other than those stated in the MAR, have been much less significant in the context of the EU than in the US. This finding has been in line with the statistical data that show that the number of OMRs in the EU has not been as large as in the US, and more specifically, dividends have still been the most common payout method in the EU, unlike in the US. Consequently, this chapter has argued that this has been primarily due to the persistence of the Continental European economic and corporate model in the EU, in which OMRs are not much needed.

This chapter has argued that the lower number of OMRs in the EU in comparison with the US could also be owing to the apathy of well-informed corporate actors to exploit OMRs. The adoption of the ineffective regulatory framework on OMRs, which are inflationary, non–obligatory, bargain, and disproportionate series of transactions in nature, would theoretically cause the potential drawbacks associated with the abuse of OMRs in the US to occur in the EU as well. Yet, EU managers, who have the authority to trade on their own shares and shares of companies while having access to inside information, can theoretically exploit OMRs through direct or indirect insider trading . However, this chapter has suggested that, notwithstanding that there has not been much difference between the EU and the US with respect to the possibility for managers to engage in direct insider trading, managers of most EU companies typically have fewer financial incentives to exploit OMRs than their US counterparts. On the other hand, engaging in indirect insider trading via OMRs could be much more difficult for managers of EU companies. This has been mainly because the OMR rule in the EU, unlike that in the US, prescribes a voluntary pre–repurchase disclosure requirement that, once fulfilled, likely to increase share prices prior to actual OMRs and make actual OMRs much less lucrative for managers. The EU version of the rule also prescribes a more detailed and timelier ex post mandatory disclosure and reporting requirements for companies that theoretically enable market authorities to more easily detect indirect insider trading than in the US. Managers may also indirectly benefit from the combination of actual OMRs and their stock-based compensation. Yet, executive compensation has been conditioned to certain share price and EPS levels to be reached in periodic financial reports and OMRs inflate share prices and EPS to those levels that are set for managers to be entitled to their stock options and stock awards. However, this chapter has argued that the potential of such exploitation has been much lower in the EU than in the US because the stock-based compensation in the EU—even though the percentage of stock-based compensation to total executive compensation has increased—still comprises a smaller portion of executive compensation as compared to their counterparts in the US.

This chapter has argued that large shareholders may also exploit OMRs since they have more information than retail shareholders in the assumption that the cost of information acquisition is fixed. However, the ownership in most EU companies has been concentrated in the hands of controlling shareholders that likely have access to inside information, and for the very reason, they have been subject to insider trading rules. Moreover, controlling shareholders inherently make relational investing and thereby pursue strategic interests so that they do not favour any forms of payout and do not tend to exploit OMRs. On the other hand, a few large EU companies have relatively dispersed ownership as a result of share issue privatizations, within which they have received investments from individual shareholders as well as foreign institutional shareholders, particularly hedge funds. As in the US, hedge funds have financial interests and thereby favour shareholder payouts especially in the form of OMRs owing to their financial benefits. Moreover, active institutional shareholders usually hold minority stakes and have superior information instead of inside information and thereby would not be subject to insider trading rules. Thus, active institutional shareholders having superior information on companies may still adjust their trades and exploit OMRs at the expense of less-informed shareholders in the EU as well.

Moreover, this chapter has argued that managers of certain EU companies, particularly of those large privatized companies, have increasingly had financial incentives via stock-based compensation that could be bolstered by OMRs in the short-term in parallel with the increase in the frequency of periodic financial reports. On the other hand, many active institutional shareholders that usually invest in these large privatized EU companies, have been hedge funds that not only actively monitor management but also actively engage in business decisions in order to satisfy high financial expectations of their sophisticated investors. These pressures would cause the investment horizons of hedge funds to become shorter so that they would favour short-term policies including OMRs that inflate share prices and EPS. The alignment of interests of managers and short-term shareholder activists with respect to OMRs would cause companies to excessively execute OMRs in the EU as well. Excessive use of OMRs would result in cash being squandered via OMRs instead of being spent on long-term investment projects that would ultimately come at the expense of long-term interests of companies and their stakeholders.

Indeed, the EU has acknowledged the increasing short-term thinking and has responded by way of a series of amendments that aimed at disincentivizing managers to think short-term by reducing the frequency of financial reporting and encouraging long-term shareholder engagement. Moreover, most EU companies persist in the Continental European corporate model, in which managers have functional orientation rather than financial orientation and controlling shareholders have strategic interests as opposed to financial interests. Consequently, most companies in the EU do not prefer to execute OMRs as much as their US counterparts that would result in much reduced risk of OMR-induced underinvestment. In light of these findings, this chapter has argued that—despite the substantial convergence of the OMR regulation in the EU towards the ineffective rule in the US that has exposed the EU to potential drawbacks of OMRs—the persistence of Continental European economic and corporate model and the partial reflection of this persistence to the OMR regulation as well as quick regulatory responses to short-term thinking are likely to result in the potential drawbacks that could arise from the abuse of OMRs in the EU to occur only in a limited number of companies and thereby to be less severe than in the US.

CHAPTER IV. REFORMING THE RULES ON OPEN MARKET REPURCHASES IN THE US AND THE EU

A. Introduction

Global competitive pressures induced the liberalization trend, initially in the US and later in the EU. As part of this trend, rules governing markets and corporations were deregulated. The deregulation includes the (de)regulation of OMRs in the US[610] and the EU[611] with the adoption of the safe harbor rules on both sides of the Atlantic. The safe harbor rules seek to protect managers from allegations based on anti–manipulation provisions and insider trading rules as long as OMRs are executed in compliance with the requirements prescribed by the rules. The intention of both market regulators in enacting the safe harbor rules has been to allow corporations to more easily execute OMRs. Yet, OMRs appear to be beneficial tools for the increasingly shareholder-centered corporations operating in increasingly financialized economies. That is, OMRs serve corporations and shareholders in the US, and, to a lesser extent, those in the EU. Consequently, OMRs have become common market practices for the last four decades in the US, and, again to a lesser extent, for the last two decades in the EU.

On the other hand, OMRs also have the potential drawbacks discussed in previous chapters. The potential drawbacks exist due the combination of the inflationary and non–obligatory nature of OMR announcements and the inflationary, bargain, and disproportionate nature of actual OMRs.

[610] *See supra* Chapter II.B.4.
[611] *See supra* Chapter III.B.5.

These features of OMR announcements and actual OMRs enable more informed market actors, i.e., primarily managers and also active institutional shareholders, to exploit OMRs at the expense of less-informed shareholders via direct and also indirect insider trading. The ability of both managers and active institutional shareholders to exploit OMRs would cause their interests to be aligned with respect to OMRs. Meanwhile, the interests of managers and certain active institutional shareholders, namely short-term shareholder activists led by hedge funds, have increasingly become financial and shorter. Thus, the alignment of shorter-term interests of managers and shareholder activists would cause management to pursue short-term strategies including OMRs. Consequently, the excessive use of OMRs might lead to underinvestment, which would adversely affect corporations and corporate stakeholders having long-term interests including long-term shareholders.

However, the potential of abuse of OMRs had been understated by the lawmakers so that it now appears such abuses have gone undetected due to the ineffectiveness of existing rules on OMRs both in the US and the EU. Indeed, despite the record-breaking number of OMRs in the US, no OMR-related lawsuits have been brought in the US.[612] Although the EU enacted a prima facie stricter version of the safe harbor rule than in the US, there has been only one known OMR-related case brought before the European Court of Justice,[613] despite the dramatic increase in the number of OMRs in the EU. A number of SEC commissioners have also recently acknowledged the inefficiency.[614] However, the SEC has not taken any action thus far. Therefore, further research has been conducted and various regulatory proposals have been made in the US.[615] These proposals

[612] *See supra* Chapter II.D.1.1.1.
[613] *See supra* Chapter III.D.1.1.1.
[614] *See supra* note 10 and accompanying text.
[615] *See infra* Part B.

range from radical political measures to be implemented by legislatures to technical amendments that could be adopted by market authorities.

Although the OMR rule in the EU has essentially been similar to the OMR rule in the US,[616] which has been ineffective in dealing with market abuse, the effectiveness of the OMR regulation has not been discussed in the EU as much as in the US. As this dissertation suggests, this might have been mainly due to the persistence of the Continental European economic and corporate model, in which companies need not use OMRs as frequently as in the US so that potential drawbacks would be less severe in the EU than in the US. Such persistence seems to have been partly reflected in the regulation of OMRs as there have been a few regulatory technical differences that make the OMR rule in the EU stricter than that in the US. Nonetheless, the OMR rule in the EU has essentially been a safe harbor rule like that in the US that has been ineffective in dealing with market abuse, and its differentiating elements have their own weaknesses and strengths.

Hence, this chapter rigorously evaluates proposals that were raised by previous research in the US as well as regulatory technical differences that make the OMR regulation in the EU stricter than that in the US. The objective is to come up with a proposed regulatory framework that could eliminate potential drawbacks of OMRs while maintaining purported benefits of OMRs on both sides of the Atlantic. For this purpose, as this dissertation has claimed that the increase in the number of OMRs has been mainly due to the ability of those having superior information to exploit OMRs, this chapter suggests that OMRs must be addressed by market authorities (rather than legislatures). This is because market regulators would be better off addressing the potential of

[616] *See supra* Chapter III.B.5.

market manipulation and informed trading via OMRs, which would reduce the number of OMRs. Such reduction would mitigate, if not eliminate, the adverse consequences of OMR-induced underinvestment while allowing corporations to execute OMRs for legitimate business purposes. For this reason, this chapter seeks to come up with a number of proposals that would be easily compatible with the existing OMR rules in order to be implemented in the short-term.

More specifically, this chapter recommends that market authorities make a number of regulatory technical amendments to the existing OMR rules both in the US and the EU.[617] The main component of regulatory proposals identified in this chapter includes the amendment of current disclosure regimes in the US and the EU. Notwithstanding that previous research has made similar proposals for the amendment of the disclosure regime in the US, this chapter additionally draws lessons from the comparative approach and seeks to offer a more detailed and timelier disclosure requirement. Such a disclosure requirement would incur additional costs on corporations while enabling market authorities to monitor the OMR activity of corporations more effectively. For these reasons, a more detailed and timelier disclosure regime might deter corporations from excessively executing OMRs.

Additionally, this chapter couples the proposal to enhance the disclosure regime with a proposal to increase the oversight ability of market authorities on OMRs. This dissertation suggests that the enhanced disclosure regime would only make sense when market authorities would effectively monitor the OMR activity of corporations based on detailed information disclosed. An effective oversight based on effective information disclosure might deter those having superior information

[617] *See infra* Part C.

from exploiting OMRs. These regulatory proposals have been the end-product of this dissertation that sought to determine under what conditions OMRs could be exploited in a way to harm markets. The combination of these proposals addresses these conditions and recommends that market authorities internally develop best practice guidelines. Hence, market authorities would better understand the illegal intent, if any, of those having superior information and to enforce anti–manipulation provisions and insider trading rules when necessary.

This dissertation also develops a series of proposals that would complement the main regulatory proposals to eliminate the potential drawbacks of OMRs by reducing the excessive number of OMRs.[618] The first proposal recommends that market authorities require corporations to disclose, if any, trading restrictions that they impose on themselves and their insiders during the OMR program. The second proposal suggests that corporations provide dividend protection to executive stock options that might incentivize managers to choose dividends over OMRs. This proposal also advises market authorities to require corporations whether and to what extent they provide dividend-protected compensation schemes. The third proposal involves a recommendation to the SEC to revise short-swing profit provision for stock options. This proposal also recommends to all market authorities to monitor the ability of managers to reap shot swing profits via stock options around OMRs. Another proposal would be to recommend that debtholders put covenants in order to restrict corporations to finance OMRs via debt. Finally, this dissertation also suggests that market authorities should educate investors to enable them to make more informed decisions with regard to OMRs, if not activate private enforcement.

[618] *See infra* Part D.

Since these regulatory proposals amount to an increase in regulation that would incur certain costs, this dissertation makes a cost-benefit analysis.[619] First, this chapter acknowledges that any proposal to increase regulation might deter market regulators from implementing the proposal. Such deterrence typically occurs due to the cognitive biases that market authorities may have, as well as potential political pressures and budgetary constraints market authorities would face. Thus, this chapter takes into consideration these factors and opt to make amendments to the existing rules without changing the regulatory approach for the time being. Second, the regulatory proposals put repurchasing corporations to expense due to time and services needed to fulfill the more detailed and timelier disclosure requirements. However, these costs turn out to serve the main purpose of the proposals, since these costs might deter corporations from excessively executing OMRs. Third, the proposal to increase oversight on OMRs would place a financial burden on market authorities. However, the increased oversight would increase the potential risk of corporations facing public enforcement so that it might deter corporations from executing OMRs. Such deterrence is likely to decrease the number of OMRs that need to be monitored. This chapter also reviews the potential costs of complementary proposals. However, these costs would be trivial since these proposals are deliberately chosen to not put market authorities and/or market actors to great expense.

This chapter consists of four parts. The first part reviews regulatory proposals made by previous studies. The second part proposes technical amendments to the existing OMR regulations in the US and the EU. The third part offers proposals, which would complement those proposed technical amendments, which might have the effect of curbing the excessive OMR activity and eliminating

[619] *See infra* Part E.

the potential drawbacks of OMRs. This chapter concludes with an analysis of the costs and benefits of all the proposals raised by this dissertation.

B. Review of Previous Regulatory Proposals on OMRs

Previous research has made various regulatory proposals that this part categorizes and evaluates in two sections. The first section reviews proposed political measures that might be taken against OMRs by legislatures. The second section enumerates previously proposed technical measures that could be taken by market authorities to regulate OMRs.

1. Proposed Political Measures

Previous research has proposed a number of political measures against the abuse of OMRs that could be taken by legislatures. This section reviews these proposed political measures by categorizing them into three subsections: to impose an outright ban on OMRs, to make OMRs conditional on corporate social performance, and to increase tax liability for OMRs.

1.1 Imposing an Outright Ban on OMRs

The first and undoubtedly the boldest proposal would be to impose an outright ban on OMRs.[620] This proposal has also been endorsed by a proposed act that has recently been introduced in the

[620] Lazonick, *supra* note 42, at 439 (suggesting that corporate stock repurchases should be banned).

US.[621] The proposed act included an outright ban on OMRs by repealing the Rule 10b-18. However, the proposed act has not been enacted. Yet, it must have been affirmed by a legislature that consists of political groups with dissenting opinions. As a matter of fact, it was very unlikely for a divided legislature to come to terms on such a radical proposal concerning a highly contentious market transaction that has both positive and negative aspects. Fundamentally, this study has been legal research that is inherently built on the universal legal reality that corporations have legal personality distinct from corporate constituents. The corollary of this reality is that corporations must have the right to repurchase their own shares on the open market, just like any other persons, but these transactions must be regulated as they would inherently create conflict of interests. Moreover, upon extensive review of purported benefits of OMRs, this dissertation suggests that OMRs may be beneficial to corporations under certain circumstances. Thus, the proposal to completely ban OMRs would be incompatible from a legal point of view and too radical in so far as it disregards the benefits of OMRs while seeking to eliminate the potential drawbacks arising from the abuse of OMRs.

1.2 Linking OMRs to Corporate Social Performance

Another proposal that could be implemented by a legislature would be to link a corporation's ability to execute OMRs to certain corporate variables.[622] Since a legislature would seek to uphold larger social values, they might want to condition the ability of a corporation to repurchase its own shares on the open market to certain variables. One of these variables was the portion of profits

[621] The Reward Work Act, H.R. 6096, 115th Congress (2018). For the exact same proposal that was introduced again in 2019, see the Reward Work Act, H.R. 3355, 116th Congress (2019). These acts also proposed a requirement for listed corporations in the US to enable employees to elect one-third of the board of directors.

[622] Lenore Palladino, *The $1 Trillion Question: New Approaches to Regulating Stock Buybacks*, 36 YALE J. ON REG. BULL., Nov. 8, 2019, at 89, 103–04.

allocated to raising wages for workers.[623] Other variables might also link the ability of a corporation to execute OMRs to prerequisites like a median worker-to-CEO (chief executive officer) compensation ratio or job creation metrics.[624] Alternatively, corporations could be prohibited from executing OMRs if they have unfunded pension liabilities, announce layoffs, fail to meet a certain level of productive investment, have wage dispersion below a certain threshold, or have executive compensation above a certain limit.[625] Again, such proposal is not easy to implement due to political disagreements in the US and elsewhere. Moreover, linking a corporation's repurchasing ability to such variables may create unforeseeable problems especially for corporations, while failing to specifically address the potential drawbacks posed by OMRs.[626]

In a similar vein, the Stock Buyback Reform and Worker Dividend Act of 2019 proposed to require corporations to provide an annual dividend to employees in proportion to the total amount of corporate payouts.[627] Meanwhile, the proposed act has also proposed to replace the Rule 10b-18 drafted by the SEC with a distinct rule under Section 9 of the Securities Exchange Act of 1934. [628] Contrary to the current safe harbor rule, the proposed act included a prescriptive rule and

[623] *See, e.g.*, The Worker Dividend Act of 2018, S. 2505, 115th Congress (2018). The act had proposed an amendment to the Internal Revenue Code to apply tax on corporations that fail to allocate a portion of profits to raising wages for workers that is proportionate to OMR spending. For the exact same proposal that was introduced again in 2019, see The Worker Dividend Act of 2019, S. 2514, 116th Congress (2019). Similarly, see the Stock Buyback Reform and Worker Dividend Act of 2019, S. 2391, 116th Congress (2019) [hereinafter referred to as Stock Buyback Reform and Worker Dividend Act of 2019]. The Act has proposed a requirement for corporations to provide an annual dividend to employees based on the amount corporations spend on stock buybacks, dividends, and special dividends.
[624] Palladino, *supra* note 622, at 103–04.
[625] *Id.*
[626] Even if such proposal might have the effect of mitigating the adverse consequences of OMR-induced investment on corporate stakeholders led by employees, it would be unable to prevent those exploiting OMRs from harming less-informed shareholders and undermining markets.
[627] Stock Buyback Reform and Worker Dividend Act of 2019, § 4.
[628] Stock Buyback Reform and Worker Dividend Act of 2019, § 3.

substantive requirements, like the previously proposed rules of the SEC in the 1970s.[629] According to the proposed act, OMRs shall be unlawful as a fraudulent, deceptive, or manipulative act or practice unless corporations comply with the requirements prescribed by the rule. These requirements include a slightly stricter trading condition like the proposed rules preceding the Rule 10b-18 in the US (i.e., lowering the volume condition from 25% to 15%). Moreover, the proposed act prescribed a detailed pre–repurchase disclosure requirement, a timelier ex post disclosure requirement, and trading restrictions on corporations.

All of these features included in the Stock Buyback Reform and Worker Dividend Act of 2019 have already been prescribed by the EU as additional requirements that corporations must comply in order to benefit from the safe harbor protection. Since this dissertation predominantly makes regulatory proposals to the SEC in the light of the additional requirements prescribed by the EU, some of the regulatory proposals raised by this dissertation overlap with certain elements of the Stock Buyback Reform and Worker Dividend Act of 2019. However, unlike this dissertation, the proposed act offered a substantial change in the regulatory approach from safe harbor rule to a prescriptive rule with bright-line limits. Apart from skepticism on the fairness of bright-line rules, a prescriptive rule might impair benefits of OMRs while potentially increasing the legal certainty historically associated with the increase in the number of OMRs.[630]

Moreover, the proposed act sought to evade the regulatory authority delegated to the SEC with respect to OMRs while leaving the regulation of all other repurchasing methods to the discretion

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[629] *See supra* Chapter II.B.3.

[630] For the argument that the legal certainty caused an increase in the number of OMRs in the US, see Grullon & Michaely, *supra* note 3. For the same finding in the EU, see Siems & De Cesari, *supra* note 422.

of the SEC. On the other hand, the proposed act delegates the power of making additional regulation to the SEC. That is, the proposed act projected to authorize the SEC to establish further disclosures, conditions, or requirements to increase the information provided by corporations with respect to OMRs. Instead of this complicated and potentially costly procedure, this dissertation recommends that the SEC continue to exclusively regulate OMRs and incorporate regulatory proposals into the current safe harbor rule. Such approach would enable market authorities to collect sufficient data to analyze OMR activity prior to considering any such change in regulatory approach within the light of collected data.

1.3 Increasing Tax Liability on OMRs

A legislature may also seek to address excessive OMR activity by discouraging corporations from executing OMRs through increasing shareholders' tax liability attributed to gains received from OMRs. In contrast to gains generated from dividends which are subject to ordinary income tax, gains associated with OMRs are subject to capital gains tax. Thus, a hike in capital gains tax could be proposed in order to discourage corporations from using OMRs and encourage them to use dividends instead.

Notwithstanding that the number of OMRs has dramatically increased in the US despite the gradual loss of the historic tax advantage of OMRs over dividends,[631] dividends have never had the tax advantage over OMRs. Hence, considering that tax rates on dividends and OMRs are now equal, levying an additional tax on OMRs might be thought to curb OMR activity and increase

[631] *See supra* Chapter II.C.1.1.

dividends. However, many shareholders, who are able to exploit OMRs, have already been either tax-exempt or subject to lower tax brackets and tend to pressure management to execute OMRs. Moreover, such a fundamental tax proposal is likely to have other implications on the economy, since capital gains taxes apply not only to OMRs.

On the other hand, another tax proposal would be to levy a financial transaction tax with respect to OMRs.[632] A financial transaction tax could be accrued to corporations repurchasing their own shares on the open market. That is to say, it would lay an additional financial burden on repurchasing corporations and affect those who are able to exploit OMRs only indirectly. Thus, this proposal would be unlikely to inhibit those having short-term interests, namely short-term shareholder activists and self-interested managers, from causing corporations to excessively execute OMRs that may come at the expense of corporations and their stakeholders.[633]

2. Proposed Technical Measures

Apart from proposed political measures against the abuse of OMRs, previous research has proposed various technical measures for the regulation of OMRs that could be adopted by market authorities. This section reviews these proposals by categorizing them into four subsections. These proposals include the repeal of safe harbor rules, the replacement of safe harbor rules with new rules, amendments to current rules by enhancing disclosure regimes or the stipulation of additional requirements.

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[632] Palladino, *supra* note 622, at 103–04.
[633] *See supra* Chapter II.D.2.1.

2.1 Repealing Safe Harbor Rules

Current rules on OMRs both in the US and the EU are known as safe harbor rules.[634] Safe harbor rules protect corporate insiders from potential liability based on anti–manipulation provisions and insider trading rules as long as OMRs are executed pursuant to trading conditions (and restrictions) laid out in these rules. As noted above, the adoption of these rules removed the ambiguity associated with the absence of regulation on OMRs.[635] Hence, one proposal would be to repeal safe harbor rules so that ambiguity arising from the legal gap might again deter corporations from executing OMRs.[636]

Indeed, safe harbor rules might have contributed to the increase in the number of OMRs by bringing about legal certainty and allowing corporations to more easily execute OMRs. However, this dissertation has further argued that the main reason for the increase in the number of OMRs has been multiple functions of OMRs within the economic and corporate model that have substantially changed towards finance capitalism and shareholder value maximization in the US in the 1980s (and in the EU in the 2000s).

Moreover, safe harbor rules fail to deter corporations from excessively executing OMRs since they have also been somewhat ambiguous and not directly enforceable. Such failure has mainly been due to the fact that these rules had been enacted by market authorities when they had a stance in

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[634] For further information on the safe harbor rule in the US, see *supra* Chapter II.B.4. For further information on the safe harbor rule in the EU, see *supra* Chapter III.B.5.

[635] *See supra* note 630 and accompanying text.

[636] Palladino, *supra* note 622, at 102.

favour of OMRs.[637] Thus, even if safe harbor rules are to be repealed to reinstate the ambiguity to deter corporations from excessively executing OMRs, corporations would likely continue to execute OMRs as frequent as is now, unless market authorities expressly state a change of stance and the embodiment of such change in the form of effective oversight and public enforcement when necessary.

2.2 Replacing Safe Harbor Rules with Prescriptive Rules

Another proposal would be to adopt a regulatory approach similar to that prescribed by the proposed rules that preceded the safe harbor rule in the US.[638] Those proposed rules prescribed substantive limits on OMRs by making trading conditions (i.e. timing, price, volume and the manner of repurchase) laid out in safe harbor rules mandatory.[639] These proposed rules also left to the discretion of the SEC to accept or reject a corporation's proposed OMR plans after analyzing them on a case-by-case basis.[640] That is, the main difference between safe harbor rules and prescriptive rules is that OMR transactions outside safe harbor rules do not automatically constitute market abuse, whereas transactions that do not abide by prescriptive rules would automatically be unlawful.

Unlike safe harbor rules, prescriptive rules sought to restrict a corporation's ability to execute OMRs with arbitrary bright-line rules that might impair some of the purported benefits of OMRs.

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[637] *See supra* note 24 and accompanying text.
[638] Palladino, *supra* note 622, at 102. *See also supra* note 629 and accompanying text for the review of the Section 3 of the Stock Buyback Reform and Worker Dividend Act of 2019 that had proposed a prescriptive rule to replace the safe harbor rule.
[639] *See supra* Chapter II.B.3.
[640] *Id.*

Additionally, the proposal to authorize market authorities to proactively monitor each and every OMR program on a case-by-case-basis would constitute interference in corporate decisions made within the discretion of managers. Such proactive oversight may also impose a burden on market authorities that could be heavier than the oversight mechanism outlined by this dissertation. Moreover, the SEC radically shifted from these prescriptive rules to the current safe harbor rule with no satisfactory explanation.[641] The fact that these proposed rules have been rejected several times raises doubts concerning whether the SEC (and other market authorities) would want to radically shift back to the regulatory approach that seeks to substantively restrict a corporation's ability to execute OMRs.

2.3 Enhancing Disclosure Requirements

Another proposal suggests that the SEC should enhance the current disclosure regime through introducing a timelier ex post disclosure requirement, namely to disclose details of OMR programs just a few days after the execution of transactions under these programs.[642] Timely disclosure requirements would not be sufficient to curb OMR activity by themselves. However, they would provide necessary information on a timely manner that would help market authorities to monitor OMR activity and, if necessary, investigate repurchasing corporations and their insiders. With the current disclosure regime, the SEC does not have the data necessary to evaluate when the rule has been violated. This is because, apart from the lack of information content of disclosures, it is hard

[641] *See supra* note 113 and accompanying text.
[642] Fried, *supra* note 246 (proposing to subject repurchasing corporations to the same trade-disclosure rules imposed on their insiders, namely the 2-day disclosure rule that requires insiders to disclose their trades). *See also* Stock Buyback Reform and Worker Dividend Act of 2019, § 3 (incorporating a similar disclosure requirement that requires corporations to disclose their OMR activity in any calendar week not later than the last business day of the following week to the SEC).

for the SEC to track down transactions, the details of which are announced on quarterly and annual statements.[643] In this sense, the OMR regulation in the EU sets a better example since companies are required to report their OMR activity to market authorities and disclose the details of each OMR transaction no later than by the end of the seventh daily market session following the date of the execution of the transaction.[644] Hence, this dissertation seconds the proposal to advise the SEC to require corporations to timely disclose details of OMR programs after-the-fact.

Again, another proposal for the SEC would be to impose a pre–repurchase disclosure requirement in order to reduce profits that managers can reap by engaging in indirect insider trading via OMRs.[645] This particular proposal is essentially the same as the pre–repurchase disclosure requirement in the EU.[646] However, unlike the pre–repurchase disclosure requirement in the EU, the proposal prescribes a mandatory and binding pre–repurchase disclosure requirement that would be followed by an actual repurchase.[647] Such requirement would contain the maximum number of shares to be acquired, the maximum price to be paid per share and the duration of the program prior to the start of the OMR program.[648]

643 White's Letter, *supra* note 270, at 3.
644 Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(2)–(3), at 37.
645 Fried, *supra* note 43, at 1376–80 (proposing that corporations disclose specific details of their buy orders before actual repurchases). Fried also states that the pre–repurchase disclosure should be made at least several days in advance of the start of trading in an OMR program so that the information contained in the announcement will be incorporated into the share price. A similar waiting period, which usually is fourteen days, applies to 10b5-1 Trading Plans. *See also* Stock Buyback Reform and Worker Dividend Act of 2019, § 3 (incorporating a similar disclosure requirement for corporations to disclose their OMR program to the SEC on a Form 8-K on or before the date on which corporations begin repurchasing their shares).
646 Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37. The rule does not specify a waiting period.
647 Fried, *supra* note 43, at 1384.
648 *Id.* at 1375–76.

The particular proposal seeks to rule out the possibility of corporations making misleading announcements and makes it certain that corporations will actually execute OMRs. The increased certainty will increase the credibility of the information content of disclosure. The increased credibility will increase the market reaction. The increased market reaction will translate into an increase in share prices and force corporations to repurchase shares at a higher price.[649] Repurchasing shares at a higher price will ultimately reduce profits that managers (as well as other non–selling shareholders) would indirectly make.

However, inflated share prices would provide managers aa wider price spread to exploit OMRs via direct insider trades. Such wide price spread would be a concern especially when the ineffectiveness of enforcement of anti–manipulation and insider trading rules are taken into consideration.[650] More importantly, in case this proposal is implemented, OMRs would resemble repurchase tender offers. Thus, problems inherent in repurchase tender offers would likely occur in the case of OMRs. That is to say, corporations would be obliged to repurchase their own shares at inflated prices via OMRs and such purchases would harm corporations and thereby non–selling shareholders including long-term shareholders. Alternatively, share prices might exceed the maximum price to be paid per share so that corporations would be unable to execute OMRs and the OMR program would fail. For these reasons, this dissertation disagrees with the proposal to require corporations to disclose details of OMR programs prior to the start of each program.

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[649] *Id.* at 1376–80. For the inflationary effect of the pre–repurchase disclosure requirement on share prices in Germany, see Hackethal & Zdantchouk, *supra* note 497.

[650] In order to eliminate this potential drawback, Fried repeats one of his previous proposals in that managers of repurchasing corporations should also be required to disclose their own intended trades in advance. *See* Fried, *supra* note 43, n.163 at 1380. For further information on this proposal, see Jesse M. Fried, *Reducing the Profitability of Corporate Insider Trading Through Pretrading Disclosure*, 71 CAL. L. REV. 303 (1998).

2.4 Stipulating Additional Requirements to the Existing Rules

Another set of proposals suggests that the SEC could focus on corporate governance.[651] The first proposal is that the SEC may require corporations to allow only disinterested directors to authorize repurchase programs.[652] However, neither the SEC nor securities exchanges have the authority to enact requirements on how the authorization to execute OMRs should be allocated. Rather, these governance provisions fall within the scope of corporation laws of each state. A second proposal is that the SEC could require corporations to limit financial resources available for OMRs.[653] In the EU, corporations may only use distributable profits to finance OMRs, and OMRs may not have the effect of reducing the net assets below the subscribed capital plus non–distributable reserves.[654] However, again, imposing such a requirement on corporations falls within the scope of corporation laws of each state in the US. States have similar legal capital mechanisms as those in the EU, but not as strict. States would likely be reluctant to implement stricter requirements that would further limit the power of a corporation respecting its power to purchase of its own shares.[655] Instead, this dissertation suggests that the SEC require corporations to disclose how managers are authorized and what financial resources they allocate to finance OMRs. The SEC may also take this information into consideration as additional indicators while trying to find out real intents of corporate insiders in executing OMRs.

[651] Palladino, *supra* note 622, at 102.
[652] *Id.*
[653] *Id. See also* Robert A. Kessler, *Share Repurchases Under Modern Corporation Laws*, 28 FORDHAM L. REV. 637 (1959) (suggesting that, in order to protect the interests of both creditors and shareholders, model corporation laws must impose both the bankruptcy and equity insolvency restrictions on all share repurchases and limit the general repurchases to actually earned surplus so that they would prevent not only a diminution of the asset fund below stated capital, but also circumvention of the latter restriction through its loopholes).
[654] Directive 2017/1132, *supra* note 429, art. 56(1), at 74.
[655] For the reasons for the potential reluctance of states in adopting stricter requirements, see *supra* Chapter II.B.1.

Finally, another proposal would be to prohibit insiders from trading during an OMR program.[656] A similar but a general prohibition exists in the EU.[657] On the other hand, the SEC seems to deliberately abstain from imposing any such requirement that would prohibit any corporate actors from trading in any time. Rather, such blackout periods and trading windows have been left to the discretion of corporations to regulate in their bylaws in the US. Hence, this dissertation recommends that the SEC require corporations to disclose, if any, measures taken to prevent insiders from trading and themselves from selling during OMR programs. By this way, the SEC would be able to monitor if corporations have such measures in place, and scrutinize whether and to what extent such measures are complied with, and if not, whether there is any fraudulent intent in executing OMRs.[658]

C. Regulatory Technical Proposals

The main organizing principle of market authorities, both in the US and the EU, has been information disclosure with respect to the regulation of OMRs. Corporations are required to disclose information on OMRs in order to provide market authorities as well as the public necessary information to oversee the OMR activity of corporations.[659] However, the disclosure regime in the US has been ineffective in that it is neither detailed nor timely. Despite having a more rigorous disclosure regime, there have also been certain pitfalls in the EU disclosure regime. Hence, the first section initially compares current disclosure regimes in the US and the EU and

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[656] Palladino, *supra* note 622, at 102.
[657] Market Abuse Regulation 596/2014, *supra* note 447, art. 19(11), at 40.
[658] *See infra* Part D.1.
[659] *See supra* Chapters II.B.4, III.B.5.

demonstrates problems in both disclosure regimes. By this way, the first section seeks to come up with a disclosure regime that minimizes the risk of market abuse while enabling market authorities to gather more detailed information in a timely manner.

Even if a more detailed and timelier disclosure regime is enforced, a more effective oversight mechanism should also be formed by market authorities. Market authorities typically suffer from understaffing and budgetary constraints and cannot effectively monitor the OMR activity of corporations. Moreover, OMRs are complex transactions and have become daily market practices. Indeed, despite a record number of OMRs, there has been no known OMR-related lawsuits brought against insiders in the US.[660] As for the EU, there has been only one case that was brought before the European Court of Justice in the EU thus far.[661] For this purpose, the second section of this part advises market authorities to increase the capacity of their existing enforcement body or organize a distinct body, the sole duty of which would be to effectively monitor OMRs.

1. Enhancing Disclosure Requirements

The extensive review of previous proposals particularly made for the disclosure regime in the US has demonstrated that most of these proposals knowingly or unknowingly rely on the regulatory elements that have been in force in the EU. Such reliance emphasizes the significance of this dissertation that thoroughly compares the regulatory treatment of OMRs in the US with that in the EU. Hence, this section makes regulatory proposals on disclosure regime based on the comparison

[660] For the confirmation of lack of OMR-related legal actions in the US, see White's Letter, *supra* note 270, at 2–3.
[661] *See supra* note 561 and accompanying text. It should be noted that this dissertation does not cover, if any, OMR-related legal actions taken at the national level in EU Member States.

of the OMR regulation in the US with that in the EU. In general, the disclosure framework prescribed by securities exchanges and market authorities in the US consists of two stages, whereas a three-stage disclosure regime has been prescribed by EU company and market laws.

More specifically, securities exchanges require US corporations to disclose details of board authorization given to managers, and the SEC requires corporations to disclose their OMR activity in their quarterly and annual statements. On the other hand, EU companies have been subject to disclosure requirements that are functionally similar to those in the US, and additionally, they are required to disclose details of imminent OMR programs prior to the start of each program. This section thus reviews these disclosure requirements in three headings based on the chronological order and offers various proposals regarding these disclosure requirements for both jurisdictions.

1.1 Announcements of OMR Plans

OMRs are executed by managers, managers must be authorized to execute OMRs via OMR plans, and OMR plans must be announced both in the US and the EU.[662] OMR plans must be made public because OMR plans are regarded as material information, given that it is reasonably certain that OMRs have a substantial effect on the share price. On the other hand, announcements of OMR plans do not oblige managers to actually follow through and execute the OMR plan. That is, OMR

[662] Since Article 60 of the Directive (EU) 2017/1132 instructs EU Member States to require corporations to obtain authorization for managers to execute OMRs from shareholders at the general meeting, these authorizations would inherently be made public with the reporting of general meeting resolution. Moreover, any material decision including such authorizations must be made public pursuant to Article 17(1) of the MAR. In this context, national market authorities also have their own rules that require corporations to report the decision of general meetings. *See, e.g.*, Listing Rule 12.4.5 of the FCA Handbook. In the US, securities exchanges separately require corporations to announce OMR plans. *See, e.g.*, NASDAQ Rule IM-5250-1.

announcements do not represent firm commitments. The lack of commitment allows managers to engage in false signalling and precipitates the risk for market manipulation and insider trading, as extensively discussed above.[663] Therefore, OMR announcements must be regulated in a way to more accurately and transparently disclose material information. Along with the effective monitoring of insider trades around OMR announcements, increased accuracy and transparency would enable market authorities to compare information on OMR plans with information on actual OMRs. Such oversight based on accurate information would deter corporate insiders from any misconduct including the engagement of false signaling.

The US and the EU follow different paths in regulating OMR plans and their announcements. The fundamental difference pertains to the choice of authorizing body.[664] The authorization to execute OMRs is given to managers by shareholders at the general meeting in the EU,[665] whereas it is given to managers by the board of directors in the US. The choice of authorizing body seems problematic in both jurisdictions because each choice potentially constitutes a conflict of interest. Vesting the authorization power to board of directors, which is composed of managers themselves as well as those working closely with managers, might result in an extensive authority given to managers to execute OMRs. Similarly, as explained in detail above, OMRs essentially serve

[663] *See supra* Chapter II.C.1.2 and Chapter III.C.3.1.

[664] The difference between authorizing bodies has been mainly due to the historic differences between corporate models in the US and the EU. These differences include but not limited to ownership structures as well as the different powers allocated to managers, directors, and shareholders and their different perspectives on business decisions including OMRs.

[665] It should be noted again that the authorization that is given to managers by shareholders at the general meeting in the EU requires another corporate action as the board of directors needs to make an initial statement of intention to obtain authorization from shareholders to execute OMRs. For an example of this additional procedural requirement in the UK, see FCA Handbook, Listing Rules 12.4.4–5. These rules state that the board decision to submit to shareholders a proposal to authorise managers to execute OMRs and the outcome of the shareholders' meeting regarding the proposal must be notified to a regulatory information service as soon as possible. For more information on this additional disclosure requirement, see *supra* Chapter III.D.1.1.1.

shareholders' financial interests in many respects. Hence, vesting the authorization power to shareholders, who would inherently favour OMRs, might also result in managers having broad authority on decisions regarding OMRs.

For these reasons, this dissertation suggests that market authorities take authorization procedures of corporations into consideration while investigating their OMR activity. Accordingly, with respect to US corporations, this dissertation generally agrees with Palladino's proposal in that corporations should confine the authorization power to disinterested (and independent) directors.[666] This dissertation also asserts that an optimal authorization procedure for the US, similar to the EU, would be when shareholders also have a right to say on repurchase authorizations, More specifically, US corporations may give its shareholders the right to an advisory vote on repurchase authorizations given by the board at the general meeting and require a supermajority vote in their corporate charters.

Such procedure would offer a more inclusive and informative system with the participation and approval of a wider range of shareholders that are likely to have various interests.[667] More importantly, the broad shareholder participation would allow market authorities to better

[666] For the original proposal, see Palladino, *supra* note 622, at 102 (recommending the SEC to require that only disinterested directors authorize repurchase programs). However, unlike the original proposal, this dissertation recommends corporations (not the SEC) to authorize disinterested directors and identifies disinterested directors as those having no financial incentives that could be boosted by OMRs.

[667] The voting basis (i.e. the percentage) of the supermajority vote might be determined by each corporation depending on their ownership structure. The more the voting basis is, the more inclusive the authorization process will be, and the less market authorities would suspect of potential market abuse via OMRs. It should also be noted that the SEC allows managers to omit shareholder proposals pertaining to dividends as well as repurchases. *See* 17 C.F.R. § 240.14a-8(I)(13) (2019). The *rationale* is to disallow shareholders from influencing business decisions on payout policies, the main beneficiaries of which are themselves. In this context, the proposal here would not contradict with the legal principle in that it would only allow shareholders to have an advisory vote on repurchase authorizations and to have a say particularly on the upper limit (rather than the lower limit) of OMRs.

understand views of directors as well as various shareholders on OMRs and the potential of market abuse by these market actors. Hence, this dissertation also suggests that securities exchanges require corporations to disclose, if any, more information on the advisory voting process (e.g. a brief summary of discussions concerning OMRs based on the minutes of the general meeting) along with the announcement of authorization on OMR plans.

In the US, securities exchanges require corporations to announce OMR plans, which include the announcement of board authorization and its details, whereas the SEC only deals with actual OMRs. Hence, securities exchanges must require corporations to disclose certain information on OMR plans in detail and market authorities must coordinate with securities exchanges. An enhanced disclosure requirement and a strong coordination with securities exchanges regarding OMR plans would enable market authorities to compare OMR announcements with after-the-fact disclosure of OMRs. Such comparison would enable market authorities to monitor whether and to what extent corporations fulfill their announced plans, and, if not, why they fail to do so. A pattern of discrepancy in results should alert the SEC that they need to increase oversight. Such increased oversight could deter corporations from announcing unrealistic OMR plans with the intent of manipulation and insider trading through false signaling.

Although securities exchanges in the US do not require corporations to indicate certain details of OMRs plans, the SEC requires corporations to disclose certain details of OMR announcements by footnote to tables prepared by corporations to fulfill ex post reporting requirements.[668] On the other

[668] *See supra* note 264.

hand, in the EU, announcements of OMR plans are regulated by the Directive (EU) 2017/1132,[669] and the combination of the MAR and the CDR regulating actual OMRs makes reference to this directive.[670] Additionally, market authorities in EU Member States facilitate coordination between disclosures regarding OMR announcements and actual OMRs.[671] Hence, the second set of proposal would be that securities exchanges in the US require corporations to publicly disclose certain information on OMR plans, like their EU counterparts.

While actual OMRs may take place shortly after OMR announcements, OMR announcements authorize managers to execute OMRs within a much longer period. The maximum length of authorization could be as long as five years in the EU,[672] whereas corporation laws and securities exchanges in the US remain silent as to the maximum length of authorization.[673] Hence, the first proposal here is for the securities exchanges in the US to specify a maximum length of authorization like in the EU and to require corporations to disclose the duration of the period, for which the authorization is given. The second proposal would be for the EU (and also the US in case the former proposal is implemented) to require corporations to specify a short(er)

[669] Directive 2017/1132, *supra* note 429, art. 60(1)(a), at 75. The authorization shall determine (i) the maximum number of shares to be acquired, (ii) the duration of the period for which the authorization is given, that would not exceed five years, and (iii) in the case of acquisition for value, the maximum and minimum consideration.
[670] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.
[671] *See generally* FCA Handbook, Listing Rule 12.4.
[672] *See* Directive 2017/1132, *supra* note 429, art. 60(1)(a), at 75. The Directive allows EU Member States to determine the maximum length of the duration of the period for which the authorisation is given, but it cannot exceed five years.
[673] For an idea on how long it approximately takes for US corporations to complete their repurchase targets following the OMR announcements, see Simkovic, *supra* note 126, at 110, 115 (2009) (finding that, after the amendments in 2003, completion rates have increased and it now takes around 20 months following the announcement for US corporations to complete around 80% of their announced targets and around 60% of corporations repurchase 100% or more of their announced target after 20 months following the announcement).

authorization period so that OMR announcements would contain more precise information and facilitate market authorities to much more easily examine disclosed information.[674]

Hence, this dissertation suggests that the authorization be given for a maximum of (or slightly more than) one financial year.[675] This suggestion would also be compatible with the proposal to provide shareholders advisory vote on repurchase authorizations in the US. That is, if affirmative advisory vote in the US (or authorization in the EU) is given by shareholders at general meetings, it would be given until the next shareholder meeting that would typically be held annually.[676] The time limitation on authorization period would prevent corporations from making unrealistic and/or successive OMR announcements in an effort to inflate share prices. Most importantly, such limitation would enable market authorities to more easily compare information contained in OMR announcements with the information contained in after-the-fact disclosure of actual OMR transactions examined below.

1.2 Pre–Repurchase Disclosures

The major difference between the disclosure regime of the US and the EU stems from the additional disclosure requirement prescribed by the CDR in the EU. This additional disclosure requirement advises EU companies to disclose details of each OMR program prior to the start of

[674] The SCD had initially stated that the maximum length of authorization would not have exceeded 18 months, whereas Directive 2006/68/EC extended the period to five years.
[675] *See, e.g.*, Toronto Stock Exchange Company Manual, § 628(a)(ix)(c) (2019). OMR programs last one calendar year (12 months) following the date specified in the prior notice of OMRs.
[676] In cases of extraordinary shareholder meetings, such authorization or affirmative advisory vote, if any, would be valid until the next general meeting.

trading in an OMR program in order to benefit from the exemption provided by the safe harbor rule.[677] These details include the purpose of the program, the maximum pecuniary amount allocated to the program, the maximum number of shares to be acquired, and the duration of the program.[678] However, corporations are not obliged to actually execute OMRs and fulfill the target announced in the pre–repurchase disclosure, but are advised to ensure adequate public disclosure of subsequent changes to the program and to the information already published in accordance with the rule in order to benefit from the safe harbor protection.[679]

Since pre–repurchase disclosures are to be made just before the start of trading in OMR programs, they would typically have more certainty and credibility and thereby increase share prices more than the announcements of OMR plans without such certainty.[680] The effect of such disclosures on share prices would be expected to be much higher particularly when a corporation constantly fulfills its targets announced in pre–repurchase disclosures.[681] Such increase in share prices before the execution of OMRs would reduce the ability of non–selling shareholders (that typically coincide with those having long-term interests) as well as managers, who decide not to sell their shares, to reap gains through indirect insider trading. This is because corporations would have to repurchase their own shares at inflated prices. However, since the pre–repurchase disclosure requirement in the EU does not oblige corporations to actually execute OMRs, corporations may withdraw the OMR program in the case that they find repurchases too costly to execute.

[677] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.
[678] *Id.*
[679] *Id.*
[680] For the inflationary effect of pre–repurchase disclosure requirements on share prices in Germany, see Hackethal & Zdantchouk, *supra* note 497.
[681] On the contrary, if a corporation frequently announces an imminent repurchase transaction but decides not to actually execute OMRs, the market is expected to discount the signalling power of subsequent disclosures.

On the other hand, increases in share prices following pre–repurchase disclosures would allow selling shareholders (that typically coincide with those having short-term interests) as well as managers, who decide to sell their shares, to reap personal gains by selling their own shares at inflated prices, namely through direct trades. In other words, pre–repurchase disclosure requirements may address one potential drawback of OMRs, namely indirect insider trading, while exacerbating another potential drawback, that is direct insider trading. One proposal to reduce the ability of managers to engage in direct insider trading around pre–repurchase disclosures has been to make the pre–repurchase disclosure requirement mandatory. A mandatory pre–repurchase disclosure requirement which would certainly be followed by actual repurchases and repurchasing shares at inflated prices would reduce managers' profits by imposing costs on them provided that they continue to own shares in the corporation.[682]

However, a mandatory pre–repurchase disclosure requirement would make OMRs resemble repurchase tender offers so that it would cause problems inherent in repurchase tender offers to arise in the case of OMRs. That is, corporations would have to repurchase shares at higher prices that would cause corporations to spend more than estimated. Alternatively, the increased market price will exceed the maximum price to be paid per share, which is determined based on the price condition prescribed by safe harbor rules both in the US and the EU, so that the OMR program would fail. In the former scenario, a corporation's purchase of its own shares at higher prices would increase selling shareholders' profits at the expense of corporations and non–selling shareholders

[682] Fried, *supra* note 43, at 1384.

that usually have long-term interests.[683] In the latter scenario, the failure of OMR programs would amount to the impairment of benefits of OMRs and to the use of a less efficient alternative, if any, in order to serve the intended purpose. Hence, this dissertation generally disagrees with the concept of pre–repurchase disclosure that would require corporations to disclose the full details of the program just before the start of trading.

However, one aspect of the pre–repurchase disclosure requirement in the EU is worth evaluating provided that it is paired with other disclosure requirements, particularly with the post–repurchase disclosure. That aspect is the disclosure of the purpose of the OMR program. More specifically, in order to benefit from the safe harbor protection, EU companies must disclose the purpose of each OMR program in advance,[684] and the stated purpose must be one of the three objectives that are laid out in the rule.[685] However, the EU approach fails to inhibit companies from executing OMRs for other purposes and concealing their purposes with one of the purposes stated in the rule.[686] Even if companies explicitly state that they execute OMRs for other purposes, the mere consequence would be that the particular transaction will be removed from the safe harbor rule for that day. Moreover, legitimate business purposes might vary in due course depending on various factors that might affect the business strategies of corporations regarding OMRs. Therefore, this dissertation suggests that market authorities require corporations to disclose the purpose of each OMR transaction without exclusively listing legitimate purposes, for which OMRs can be executed. An inseparable part of this particular proposal is that corporations must also include in

[683] It should be noted that, in this scenario, managers may also sell a portion of their own shares at prices increased following the pre-repurchase disclosure, whereas the increased market price would reduce managers' profits that they could derive from bargain repurchases. For further information on this discussion, see Fried, *supra* note 43, *passim*.
[684] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(1), at 36–37.
[685] Market Abuse Regulation 596/2014, *supra* note 447, art. 5(2), at 22.
[686] *See supra* Chapter III.C.3.

their detailed statements the economic reasons for the specified purpose and for the preference of OMRs over other viable alternatives, if any, in accomplishing the specified purpose.

1.3 Post–Repurchase Disclosures

Corporations are obliged to report and publicly disclose the details of OMRs after-the-fact both in the US and the EU. Unlike the pre–repurchase disclosure requirement that has been a precondition for EU companies to benefit from the safe harbor protection, the CDR has made the post–repurchase reporting and disclosure obligations mandatory for companies in the EU in 2016.[687] Accordingly, EU companies must report and publicly disclose each OMR transaction no later than by the end of the seventh daily market session following the date of the execution of the transaction, regardless of whether the repurchases are affected in accordance with the safe harbor rule.[688] On the other hand, the SEC has introduced the mandatory post–repurchase reporting and disclosure requirements in 2003. However, corporations in the US are required to report their OMR activity to market authorities on a monthly basis in quarterly and annual reports.[689]

Therefore, this dissertation agrees with the previous proposals that suggest that the SEC require corporations to timely disclose their trading activity including OMRs within a few business

[687] Although Article 5(1)(b) of the MAR prescribes the post–repurchase reporting and disclosure requirements as one of the preconditions to benefit from the protection offered by the safe harbor rule, the CDR, which is the special regulation drafted upon the instruction of the MAR, obliges corporations to report and disclose details of OMR programs after-the-fact regardless of whether repurchases are affected in accordance with the safe harbor rule. *See* Commission Delegated Regulation 2016/1052, *supra* note 67, art. 2(2)–(3), at 37.
[688] *Id.*
[689] *See supra* note 122 and accompanying text.

days.[690] The EU may also consider curtailing the 7-day period to a shorter period. Lastly, the proposal for corporations to timely report and disclose information on OMRs after the OMR program should also apply to trades in a corporation's shares made by the corporation's direct or indirect subsidiaries.[691] Such provision would prevent the corporation from evading the disclosure rule by trading indirectly through its subsidiaries.

2. Increasing Oversight Ability of Market Authorities on OMRs

The proposed technical amendments to disclosure requirements seek to enhance the disclosure regime. The enhanced disclosure regime would technically increase the probability of detection of market abuse by market authorities. The likelihood of investigation would deter those having inside or superior information from engaging in market manipulation and informed trading via OMRs. However, the enhanced disclosure regime itself would not be able to eliminate the potential drawbacks of OMRs without an effective oversight of OMR transactions from market authorities. Hence, the OMR activity of corporations must be reviewed by market authorities in light of information provided in public announcements, disclosures, and reports on OMRs. In this context, the SEC claims that it selectively reviews filings to monitor and enhance compliance with the applicable disclosure requirements.[692] However, there is no detailed information on filing review processes and the content of any such review. The absence of information on review process, taken

[690] Fried, *supra* note 246 (offering the SEC to require corporations to disclose their trading activity within two business days, just like the two-day trade-disclosure rule applicable to insider trades). *See also* Stock Buyback Reform and Worker Dividend Act of 2019, § 3 (requiring repurchasing corporations to report to the SEC their repurchasing activity carried out in any calendar week no later than the last business day of the following week).
[691] Fried, *supra* note 246, at 834.
[692] The SEC states on its website that the Division of Corporation Finance selectively reviews filings made under the Securities Act of 1933 and the Securities Exchange Act of 1934 to monitor and enhance compliance with the applicable disclosure and accounting requirements.

together with the lack of OMR-related legal actions,[693] indicate that market authorities have been unable to effectively monitor the OMR activity of corporations.

For these reasons, this part recommends market authorities to continue to have the disclosure regime as the main organizing principle on OMRs and only make technical amendments to the existing regime only if they monitor each and every OMR transaction. However, OMRs have become daily market practices, but market authorities are claimed to have suffered from understaffing and budgetary constraints.[694] Thus, market authorities must increase the capacity of their existing divisions to review filings. Alternatively, they may organize a distinct division, the sole duty of which would be to monitor certain transactions including OMRs based on detailed information timely provided through disclosure requirements. This dissertation asserts that an increase in the oversight ability of market authorities based on a more rigorous and timelier disclosure regime would more effectively enable them to collect "cogent and compelling evidence" to prove whether the defendant acts with scienter, and enforce market abuse laws when necessary.

An enforcement division that is tasked with monitoring OMRs must review all OMR transactions after-the-fact. However, this dissertation acknowledges that the market authorities might be unable to make such an extensive review due to budgetary constraints. Hence, this dissertation suggests an easily applicable test instead of requiring the enforcement division to delve into the details of each transaction at the outset. More specifically, this section suggests that the enforcement division must put OMRs to a unified test in the light of information provided in the disclosure regime

[693] *See supra* Chapter II.D.1.1.1.

[694] For a criticism on the lack of oversight capacity of the SEC in the US, see Fried, *supra* note 41, at 883 (claiming that the SEC is severely understaffed and substantial resources are needed to convict an insider for violating Rule 10b-5).

proposed above. The unified test would include the assessment of information on OMR-related procedures adopted and measures taken by corporations themselves, the inspection of compliance to OMR programs with trading conditions (and trading restrictions in the EU) and the level of information provided as well as the content of such information, and the synchronization between the OMR activity of corporations and insider trades around OMRs disclosed pursuant to trade-disclosure rules.

Hence, in the absence of an effective self-regulation that would have the effect of reducing insiders' ability to exploit OMRs, in cases of non–compliance with trading conditions (and trading restrictions in the EU)[695] laid out in safe harbor rules and other guidelines as well as omitted, incomplete or misleading disclosure, or reasonable doubt expressed regarding the presence of a suspicious act or trade, the enforcement division may proceed to a closer investigation, which may lead to public enforcement. This dissertation conjectures that an increased oversight of OMRs from market authorities based on the enhanced disclosure regime is likely to deter managers from executing OMRs with ulterior motives. Such deterrence that would ultimately result in the reduction of OMR activity. Reduced OMR activity would in turn reduce the financial burden on market authorities arising from their task to monitor all OMR transactions.

The combination of enhanced disclosure regime and increased oversight concerning OMRs would also enable market authorities to have a more transparent and effective communication with corporations. This communication would lead to the formation of a more flexible and dynamic regulatory system that can keep up with the technological and economic developments and

[695] For further information on trading restrictions in the EU, see *supra* Chapter III.B.5.

consider country-, market-, and firm-specific factors. Accordingly, if a corporation demonstrates a legitimate but unprecedented purpose to execute OMRs outside the safe harbor rule, market authorities may extend the scope of the safe harbor rule in a way to include OMRs executed for this legitimate but unprecedented purpose.[696] In these cases, the combination of the two regulatory proposals with respect to OMRs would provide flexibility for market authorities to make legal adjustments in trading conditions and restrictions according to the updated needs of corporations. Thus, corporations may benefit from the protection offered by the safe harbor rule provided that they demonstrate a legitimate but unprecedented purpose to perform OMRs that would otherwise be out of the scope of trading conditions and restrictions.

D. Complementary Proposals

In addition to the regulatory technical proposals examined above, this part makes a number of other proposals that would complement the regulatory technical proposals in order to eliminate the potential drawbacks of OMRs. To this end, the first proposal recommends market authorities to require corporations to disclose, if any, certain trading restrictions imposed on themselves and their insiders. The second proposal recommends corporations to offer dividend protection to stock options. For research purposes, market authorities may also require corporations to disclose information on the policy of corporations with respect to dividend-protected stock options. In

[696] For instance, if a corporation demonstrates an unprecedented purpose to execute OMRs and this purpose necessitates a volume condition higher than the permitted limit, market authorities may provide flexibility as to the objective and volume condition of the safe harbor rule. If this unprecedented purpose becomes common, then market authorities may consider adjusting objectives and trading conditions to the up-to-date needs of corporations. *See also* Purchases of Certain Equity Securities by the Issuer and Others, Exchange Act Release No. 61,414, 75 Fed Reg. 4713, 4714 (proposed Jan. 29, 2010) (stating that since the adoption of the Rule 10b-18 in 1982, there have been significant market changes with respect to trading strategies and developments in automated trading systems and technology that have increased the speed of trading and changed the profile of how issuer repurchases are affected).

return, the third proposal involves a recommendation specific to the SEC to prevent short swing profits via stock options. The fourth proposal recommends debtholders to include covenants to limit OMRs. Finally, this part also suggests that market authorities should further educate investors.

1. Imposing Trading Restrictions on Corporations and Corporate Insiders

Indirect insider trading is possible not only through share repurchases but also through share (re)issuances facilitated by equity offerings on the open market via at-the-market issuances.[697] In this context, the combination of OMRs and at-the-market issuances make indirect insider trading much easier for managers. Accordingly, managers, who retain their shares, may have corporations repurchase their undervalued shares at the market price via OMRs and sell shares at a higher price via at-the-market issuances on the open market.[698] Moreover, corporations may simultaneously trade their own shares in opposite directions. Simultaneously placed buy and sell orders cancel each other out and increase the trade volume. Such increase in trade volume would lead to another form of market manipulation by contributing to the perception that there is an increased interest in the shares of a corporation.

In order to inhibit the risk of market manipulation and indirect insider trading, the EU prescribes certain trading restrictions on companies. Accordingly, EU companies that wish to benefit from the safe harbor protection must not sell their own shares during an OMR program, or trade their

[697] *See generally* Fried, *supra* note 246, at 820–26.
[698] *Id.* at 820 (arguing that, just as insiders can use OMRs to buy underpriced stock through their firm, they can also use at-the-market issuances to sell overpriced shares through their firm).

own shares, except for the ongoing OMR program, during the period of 30 calendar days before the announcement of an interim financial report or a year-end report.[699] Despite the statutory restrictions on market manipulation in general terms,[700] such trading restrictions specific to OMRs have been absent in the US.[701] However, any such recommendation for the SEC to impose similar trading restrictions on corporations might contradict with the current regulatory approach of the SEC.

Hence, this dissertation recommends that the SEC require corporations to disclose, if any, information on trading restrictions imposed on the corporation by the corporation itself along with the post–repurchase disclosure on OMRs. Such disclosure would enable the SEC to take into account as one of the factors in its review process whether corporations impose blackout periods on themselves, and whether and to what extent they comply with such trading restrictions. By doing this, the SEC would have to rely on enhanced and timely disclosures concerning buying and selling activity of corporations. For this purpose, market authorities in both jurisdictions must ensure that they require corporations to disclose not only their buying activities via OMRs but also any and all their trades including selling activities, particularly via at-the-market issuances upon having an effective shelf registration statement, in a timely manner. Corporate disclosures on both buying and selling activity of corporations would enable market authorities to oversee trades of

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[699] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 4, at 38.

[700] *See* 15 U.S.C. § 78i(a) (2018).

[701] The Stock Buyback Reform and Worker Dividend Act of 2019 included a provision that prohibits a corporate executive from selling shares of the common stock of the corporation during the 7-day period beginning on the date of the repurchase announcement unless the sale of the shares involves a sale of common stock that satisfies the conditions under Rule 10b5–1 trading plans. *See* Stock Buyback Reform and Worker Dividend Act of 2019, § 3.

repurchasing corporations that are in the opposite direction of OMRs for the duration of an OMR program.[702]

The blackout periods, namely the period of 30 calendar days before the announcement of an interim financial report or a year-end report, have originally been prescribed for corporate insiders by the MAR in the EU.[703] The MAR imposes such trading limitation on insiders in addition to the trade-disclosure rule that requires insiders to disclose their trades within three business days.[704] On the other hand, the SEC requires insiders to disclose their trades within two business days under Section 16(a) of the Securities Exchange Act of 1934.[705] However, the SEC itself does not restrict insider trades with blackout periods. Instead, the SEC leaves such trading restrictions to the discretion of corporations to impose various measures on their insiders through their bylaws.[706]

In this context, Palladino had proposed that the SEC could prohibit insiders from selling their shares for the duration of the OMR program.[707] However, in line with the above proposal on a corporation's trades during an OMR program, this dissertation recommends that the SEC require corporations to disclose, if any, information on certain trading restrictions imposed on their insiders. This information would also be one of the factors for the SEC to take into consideration

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[702] Fried, *supra* note 246, at 834 (proposing the SEC to require corporations to disclose all their trades in two business days, just like their insiders).
[703] Market Abuse Regulation 596/2014, *supra* note 447, art. 19(11), at 40.
[704] *Id.* art. 19(1), at 38.
[705] *See* 15 U.S.C. § 78p(a) (2018).
[706] J. Carr Bettis, et al., *Corporate Policies Restricting Trading by Insiders*, 57 J. FIN. ECON. 191 (2000) (examining policies and procedures prescribed by corporations to regulate their insiders' trades in the stock and finding that over 92% of corporations in the sample have their own guidelines or policies restricting and/or regulating trading by insiders, and 78% have explicit blackout periods, during which the company prohibits trading by its insiders, and concluding that blackout periods successfully suppress trading, both purchases and sales, by insiders).
[707] *See supra* note 656 and accompanying text.

in its review process whether corporations impose blackout periods on their insiders with respect to OMRs, and whether and to what extent insiders comply with these trading restrictions by reviewing insider trades based on the information disclosed under the trade disclosure rule.

2. Offering Dividend Protection to Stock Options

In the US, corporations used to switch the grant date of stock options to, in most cases, an earlier date, on which the underlying share price was lower.[708] Such practice, that is colloquially known as stock options backdating, enabled those who were awarded by stock options to reap more profits by granting them the right to purchase more shares at a lower price. Hence, option holders can exercise their options without being affected by dramatic changes in share prices caused by various factors including shareholder payouts. Backdating stock options has not been illegal *per se*, namely it is legal as long as corporations inform shareholders and include in earnings and tax calculations.[709] However, the illegal use of this corporate practice urged the SEC to largely constrain this practice with the adoption of the timely disclosure of stock option grants to the SEC.[710]

The practice of stock options backdating might be, to an extent, comparable with the dividend protection mechanism, whereby corporations legally shield executive stock options against

[708] Randall A. Heron & Erik Lie, *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?*, 83 J. FIN. ECON. 271, 276 (2007).
[709] *Id.*
[710] *Id.* (reporting that the Sarbanes-Oxley Act curtailed the period for corporations to report stock option grants on Form 4 from 45 days to two business days, and finding that the new reporting requirements have greatly curbed backdating but have not eliminated it and suggesting that the requirements need to be tightened further and the SEC has to enforce the requirements).

dramatic changes on share prices caused by dividends.[711] Dividend-protected stock options might incentivize managers to prefer dividends over OMRs in distributing cash to shareholders.[712] However, dividend-protected stock options has been an uncommon practice in the US and, although to a lesser extent, in the EU.[713] Even if it was argued that most managers in the US do not regard dividend-protection as an important factor in a corporation's repurchase decision,[714] this dissertation recommends both US and EU corporations to offer dividend protection to executive stock options. Market authorities may also require corporations to disclose information on their corporate policy with respect to dividend-protected stock options. The main reason for such policy choice is to favour the use of dividends over OMRs. This is because dividends provide

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711 Arnold & Gillenkirch, *supra* note 516 (explaining that the dividend protection can be accomplished in a variety of ways, while the most common approach is to pay the executive accumulated dividends (plus interest) upon exercise of the underlying options).

712 *Id.* at 454 (claiming that the stock options that are not dividend-protected imply strict incentives for managers to cut dividends and to replace them with share repurchases, an alternative to cash dividends that does not adversely affect the value of options). Similarly, see Eva Liljeblom & Daniel Pasternack, *Share Repurchases, Dividends, and Executive Options: The Effect of Dividend Protection*, 12 EUR. FIN. MGMT. 7 (2006) (suggesting that, in Finland, the relationship between dividends and stock options is significantly positive when options are dividend protected); De Cesari & Ozkan, *supra* note 518 (finding that executive stock options are associated with lower dividend payments in European countries, whereas dividend protection for executive stock options is absent); Burns et al., *supra* note 518 (finding that dividend protected compensation is positively related to dividend payouts).

713 For the lack of dividend-protected stock options in the EU, see De Cesari & Ozkan, *supra* note 518. For the lack of dividend-protected stock options in the US, see Kevin J. Murphy, *Executive Compensation*, 3 HANDBOOK LAB. ECON. 2485 (1999) (reporting that only 7 out of 618 executive stock option programs are dividend protected in the US). However, it should be noted that, although restricted stock grants form a very small part of total executive compensation, the use of restricted stock grants have been increasing in the US, and the majority of these restricted stock grants have been dividend protected. For further information on dividend protected restricted stock grants and their relationship with repurchases, see Jolls, *supra* note 195 (finding no positive relationship between repurchases and restricted stock, since restricted stock, unlike stock options, is not diluted by dividend payments); David Aboody & Ron Kasznik, *Executive Stock-Based Compensation and Firms' Cash Payout: The Role of Shareholders' Tax-Related Payout Preferences*, 13 REV. ACCT. STUD. 216 (2008) (suggesting that stock options with no dividend protection can deter self-interested executives from using dividends as a form of payout, whereas dividend-protected restricted stock is more likely to induce the use of dividends and finding a positive relation between the increased use of dividends and the increased use of restricted stock in executive compensation).

714 Brav et al., *supra* note 155, at 508, 515 (only 10.6 percent of CFOs claim that they would use repurchases rather than dividends because stock options are not dividend-protected).

less room for exploitation than OMRs.[715] Moreover, unlike repurchases that end up disproportionately distributing cash only to selling shareholders, dividends result in a proportionate distribution of cash to all shareholders that hold their shares.

3. Preventing Short Swing Profits via Stock Options around OMRs

In the US, insiders are disincentivized from making short swing profits through the purchase and sale, or sale and purchase, of any equity security of a corporation within any period of less than six months.[716] However, in 1991, the SEC excluded executive stock options from the scope of the rule.[717] The exclusion is based on the interpretation of the SEC that stock options are derivatives so that they would not be subject to the rule until they become exercisable. The consequence of this interpretation is that the six-month waiting period would begin at the grant date, rather than the exercise date, of stock options. This change has been crucial in that the gains that derive from stock options depend on the differences between the market price on the grant date and the market price on the exercise date.[718] Since the option grant date typically occurs at least one year before the option exercise date, this reinterpretation of the rule allows managers, who exercise their stock options, to not wait for at least six months before selling these shares. In other words, managers may sell their shares immediately upon exercise of options and keep what would have previously

[715] Barclay & Smith, *supra* note 186 (arguing that OMRs, unlike dividends, provide managers with opportunities to use inside information to benefit themselves at the expense of shareholders).
[716] See 15 U.S.C. § 78p(b) (2018). The rule compels insiders to disgorge profits reaped through short swing trades to the corporation.
[717] *See* 17 C.F.R. § 16(b)-6 (2019).
[718] Lazonick, *supra* note 13, at 8.

been short swing profits, provided managers make no other transactions in the company's stock within six months.[719]

In this context, OMRs magnify this problem because (i) their inflationary effect on share prices and EPS entitles managers to stock options that depend on whether corporations reach share price and EPS targets stated in quarterly financial reports,[720] and (ii) managers' privileged knowledge of the dates, on which the corporation is actually executing OMRs, can be material information implicated in the timing of option exercises.[721] On the other hand, the EU does not have any prophylactic rule similar to the short-swing profit provision in the US, and thereby a similar problem is likely to occur in the EU as well. Hence, this section agrees with Lazonick's proposal that the SEC must revise its reinterpretation with respect to the above-mentioned problem,[722] and the SEC as well as market authorities in the EU must pay closer attention to executive stock options exercised and shares sold around OMRs.

4. Restricting Unanticipated OMRs via Debt Covenants

Another way to curb the number of OMRs might be to limit a corporation's ability to execute share repurchases, which are financed by debt, by use of debt covenants. While there might be legitimate reasons for corporations to finance repurchases via debt,[723] repurchasing shares via debt might distort financial statements and cause overleverage that might precipitate the risk of insolvency

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[719] *Id.*
[720] *Id.*
[721] *Id.* at 8–9.
[722] Lazonick, *supra* note 40, at 53–54 (advising the SEC to stop allowing executives to sell stock immediately after options are exercised).
[723] For further information on why corporations finance share repurchases via debt, see *supra* Chapter II.C.3.1.

and harm debtholders.[724] As a precaution, debtholders may put covenants that would restrict corporations to channel funds to share repurchases in the same way as they put restrictions on dividend payments. This dissertation acknowledges that, even if such covenants are put, debtholders, particularly banks, might hesitate to take measures against covenant-breaching borrowers that have been their long-standing customers. However, such long-standing relationship is likely to be built on trust and effective communication. In this context, borrowing corporations would be expected to inform lenders about their intentions on how to expend borrowed funds. Hence, this dissertation recommends debtholders to ensure that they have in place covenants on share repurchases and enforce these covenants unless borrowing corporations explicitly state their intention to expend funds to finance share repurchases.

5. Educating Investors

As argued above, the interests of managers and certain active institutional shareholders are aligned with respect to OMRs at the expense of less-informed and/or long-term shareholders. The injured shareholders may apply for legal remedies against corporate actors who are suspected to exploit OMRs. However, these shareholders are unlikely to bring private enforcement against those actors in relation to OMRs both in the US and the EU. This is because outside shareholders mostly rely on financial business metrics including share prices and EPS by making their investment decisions. OMRs, on the other hand, inflate these metrics and the inflationary effect of OMRs on these metrics might mislead shareholders and make them think that the corporation financially improves when it does not actually improve. Thus, shareholders tend to react positively to OMRs even when

[724] For the adverse consequences of debt-financed share repurchases on debtholders, see *supra* Chapter II.D.2.2.

OMRs are exploited to the detriment of corporations and their long-term shareholders. Therefore, it would be unnatural to expect shareholders, who usually react positively to OMRs, to bring legal actions due to losses of corporations (and if any, their own personal losses) incurred by manipulative and insider trading activities via OMRs.

This fallacy inherent in investors is concealed by the assumptions of informed decision and rational choice theory in neoclassical economic theory. However, behavioural finance confronts the problem, interprets such fallacy as a cognitive bias, and suggests that shareholders are overly credulous about the strategic incentives of informed corporate actors mainly due to limited attention power and overconfidence biases.[725] These biases are likely to leave less-informed shareholders vulnerable to manipulation by more-informed corporate actors that would exploit misvaluation through certain corporate actions including repurchases.[726] In this setting, corporate disclosure would also be inadequate since inherent biases, particularly overconfidence bias, may cause credulous shareholders to be unaware of their credulity and to ignore warning signs from disclosures.[727]

Consequently, although the enhanced disclosure regime proposed above would theoretically boost private enforcement of Rule 10b-5 in relation to Rule 10b-18,[728] it does not seem realistic due to

[725] Daniel et al., *supra* note 213, at 175, 177–79.
[726] *Id.*
[727] Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV., Oct. 2003, at 1, 22.
[728] Apart from the public enforcement by government authorities, investors (that contemporaneously trade with insiders) may, individually or collectively, take civil actions based on the allegation of breach of duty of insiders arising from the anti-fraud and anti-manipulation provisions and insider trading rules. Investors may also bring derivative suits on behalf of the corporation against insiders of the corporation based on harm done to the corporation. However, the private enforcement of OMR-related rules is beyond the scope of this dissertation because these legal remedies against the particular matter is exceptional especially considering the reasons stated in this section.

shareholder behavior being shaped by psychological shortcomings and cognitive biases.[729] While it is natural for shareholders to have certain psychological shortcomings and cognitive biases, market authorities and securities exchanges should inform shareholders about their psychological shortcomings and cognitive biases as well as their likely consequences.[730] In this context, this dissertation recommends that market authorities and/or securities exchanges take necessary initiatives to further educate investors on OMRs. The content of education must include the potential drawbacks of OMRs as well as potential conflicts of interest inherent in OMRs, and psychological shortcomings and cognitive biases shareholders might have that would distort their judgments including those on OMRs. This policy recommendation might enable investors to make more informed decisions on their investment decisions including OMRs; if not, take legal actions through private enforcement.

E. Cost-Benefit Analysis of Proposals on OMRs

This dissertation has made two fundamental and inseparable recommendations—namely, to enhance mandatory disclosure requirements regarding OMRs and to have market authorities to increase oversight on the OMR activity of corporations. These recommendations could easily be implemented as they are compatible with the current regulatory framework in both jurisdictions and do not require a change in regulatory approach. By doing so, this dissertation seeks to eliminate the potential reluctance of market authorities to radically change the regulatory approach. Such reluctance may arise out of cognitive biases as well as potential political pressures from certain

[729] *Id.*
[730] *Id.* at 66–69.

interest groups against a radical change in regulatory approach and the uncertainty and unanticipated costs that accompanies a new regulatory approach.[731]

That being said, this dissertation initially prescribes more informative and timelier mandatory disclosure requirements. Such requirements would expose corporate insiders to a greater risk of detection by the SEC. Meanwhile, these requirements would increase the cost and time that corporations would need to make these disclosures. The increased burden on corporations would be the strength of the proposal itself as increased costs might urge corporate insiders to scrutinize their OMR decisions that might result in the reduction of OMR activity. Moreover, the proposed disclosure regime would not be too costly to impair corporations to execute OMRs only for legitimate business purposes since many features of the proposed disclosure regime have already been in force in various jurisdictions as stated above and proven not prohibitively costly.

However, corporate insiders, who are able to exploit OMRs while having the authority to decide on OMRs, might disregard costs arising from the enhanced disclosure regime as these costs would be borne by corporations. Hence, the other fundamental proposal recommends market authorities to increase oversight on the OMR activity of corporations based on the information provided in enhanced disclosure requirements. Market authorities may increase oversight by increasing the number of enforcement staff or organizing a specialized division that would subject corporations to unified test. By this way, market authorities would be able to monitor each OMR transaction, and detect, if any, OMR activity that is carried out for market manipulation and informed trading.

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[731] *Id.*

Increasing oversight seems to place a financial burden on market authorities. However, the real cost of increased oversight would be much less than anticipated. Yet, as noted above, the potential costs associated with the more detailed and timely disclosure regime are expected to reduce the number of OMRs to be reviewed by market authorities. Similarly, the increased oversight is also expected to reduce the number of OMRs since it would increase the threat of facing public enforcement that might deter managers from executing OMRs. Moreover, the increased oversight would not be too costly for market authorities since market authorities in other jurisdictions, including but not limited to the Toronto Stock Exchange in Canada,[732] have been able to bear the costs arising from the approval process of OMR programs prior to the initiation of each program.

This study proposes a series of other proposals that would complement the proposed technical amendments. The first complementary proposal is the suggestion to market authorities to require corporations to disclose information on trading restrictions, if any, imposed on the corporation itself and its insiders along with the post–repurchase disclosure on OMRs. The disclosure of such information would enable market authorities to monitor whether corporations have trading restrictions in place for themselves and their insiders, whether and to what extent they comply with trading restrictions, and if they fail to comply what the reasons are for the failure. Similarly, but rather substantively, trading restrictions on corporations and their insiders have been available as a condition to benefit from the safe harbor protection in the EU.[733] To avoid making a substantive proposal, this dissertation recommends the SEC to enhance current disclosure requirements by requiring corporations to disclose rules, if any, that would restrict themselves to sell and their insiders to trade around OMRs.

[732] *See, e.g.*, Toronto Stock Exchange Company Manual, §§ 628–629 (2019).
[733] Commission Delegated Regulation 2016/1052, *supra* note 67, art. 4(1), at 38.

The second proposal recommends corporations to offer managers protection for their stock options from decreases in share prices following dividend payments and market authorities to require corporations to disclose their corporate policy with respect to dividend protected stock options. The objective of this proposal is to incentivize managers to prefer dividends over OMRs that would help reduce the number of OMRs and alleviate the potential drawbacks of OMRs. This dissertation makes this recommendation particularly for US corporations since the practice of dividend-protected stock options have been more uncommon in the US than in the EU.[734] This is mainly attributed to the accounting treatment of dividend-protected options in the US.[735] More specifically, pursuant to Financial Accounting Standards in the US, dividend-protected options are considered as variable-plan options because the strike price is contingent upon future events so that the cost of these options must be recognized on the income statement as compensation expense.[736] Fixed-plan options, on the other hand, do not result in a compensation expense provided that the option is granted with an exercise price greater than or equal to the current market price.[737] However, it has been argued that the different accounting treatments of variable-plan and fixed-plan options could not fully explain why corporations abstain from offering dividend protection for executive stock options.[738]

Another criticism against the proposal to recommend corporations to offer dividend-protected executive stock options might be that dividend protection provides a privilege for corporate

[734] *See* sources cited *supra* note 713 and accompanying text.
[735] Fenn & Liang, *supra* note 195, at 66.
[736] *Id.* at 66–67.
[737] *Id.*
[738] *See also* Arnold & Gillenkirch, *supra* note 516, 454 n.3 (claiming that the accounting treatment of stock options does not provide sufficient legitimation for the widespread omission of dividend protection).

insiders. Hence, the third proposal seeks to offset this given privilege by recommending the SEC to revise the short-swing profit provision that fails to prevent insiders from making short swing profits via the combination of stock options and OMRs. The proposal to revise a current rule might impose a burden on market authorities, however, the particular proposal here is to simply reinterpret or make a minor amendment that would not be too costly. This proposal also includes a recommendation to market authorities both in the US and the EU to pay closer attention to executive stock options exercised and immediately sold around OMRs. This recommendation would not cause additional costs on market authorities considering that such trades could easily be detected through matching the information provided by proposed disclosure requirements on OMRs with the information provided through the existing trade-disclosure rules on insiders.

The proposal to debtholders to draw up and enforce covenants that restrict a corporation's ability to execute and finance share repurchases via borrowed funds might be criticized that it would impair the potential benefits of share repurchases, particularly their benefits with respect to corporate finance. This concern seems unfounded, as covenants would not prohibit share repurchases as long as any plans on share repurchases and their reasons are expressly stated to the lender on the contract date and a collateral is provided. Rather, these covenants would only prohibit corporations from debt-financing share repurchases that could not be anticipated by the lender at the contract date. Unanticipated share repurchase programs executed especially for illegitimate purposes might carry severe adverse effects not only for corporate creditors but also for all corporate stakeholders. Hence, this particular proposal seeks to eliminate these severe adverse effects by recommending debtholders to ensure that they draw up and enforce repurchase covenants unless the corporation expressly states that some or all of the funds be used to finance OMRs for stated reasons and provides collateral.

Lastly, this dissertation recommends market authorities to further educate investors with respect to OMRs as well as cognitive biases that would impair shareholders' judgments including on OMRs. Thus, shareholders will be able to make more informed decisions regarding OMRs and may even initiate private enforcement based on harm done to themselves, individually or collectively, or to the corporation itself by means of OMRs. Many market authorities have a designated body, the duty of which is to educate shareholders. Hence, this particular proposal would help market authorities and/or securities exchanges to achieve one of their main objectives without imposing a significant financial burden on them. This is because shareholder education is one of the least intrusive forms of regulation and provides a low risk for regulatory error.[739]

F. Summary of Recommendations

In order to address the ineffectiveness of existing regulatory frameworks on OMRs both in the US and the EU in eliminating the potential drawbacks of OMRs, this chapter has initially reviewed previous regulatory proposals on OMRs that could be implemented by legislatures or market authorities. This chapter has agreed that market authorities are able to more precisely address the problem with custom-made amendments and maintain benefits of OMRs while eliminating potential drawbacks arising from the abuse of OMRs. More importantly, while this chapter has endorsed some of the previous regulatory recommendations directed at market authorities after

[739] Choi & Pritchard, *supra* note 727, at 67.

analyzing them in light of the comparative approach of this dissertation, it has determined that the safe harbor rules both in the EU and the US essentially function no more than best practice guidelines. Nevertheless, this dissertation has abstained from making a radical proposal in the light of legislative history as well as the prevalent regulatory approach in order to eliminate potential costs that could arise from a radical change in regulatory approach. Hence, this chapter has proposed that market authorities make a series of regulatory technical amendments to the existing rules. These amendments would extend the content of mandatory disclosures currently required within the rule and could easily be implemented into the existing regulatory frameworks.

For this purpose, this chapter has initially offered a more enhanced and timelier disclosure regime for the US mainly by taking lessons from the EU. Accordingly, this chapter has suggested that corporations in the US, where the board of directors authorize managers to execute OMRs, should confine the authorization power to disinterested (and independent) directors. Additionally, this chapter has suggested that US corporations may also give their shareholders the right to an advisory vote on repurchase authorizations given by the board through the general meeting, and also prescribe a supermajority vote in their corporate charters in order to involve shareholders having various interests into the decision process with respect to OMRs. For a more transparent and informative process, this chapter has also recommended that securities exchanges require corporations to disclose, if any, more information on repurchase authorizations and advisory voting processes along with the announcement of OMR plans.

Moreover, this dissertation has recommended securities exchanges in the US, to specify a maximum length of authorization like in the EU and to require corporations to disclose the duration of the period, for which the authorization is given. This dissertation has also made a recommendation to relevant authorities both in the EU (where the authorization period has been extended from eighteen months to five years) and the US (in case the former proposal is implemented) to specify a short(er) authorization period. This proposal has been raised to ensure that OMR announcements would contain more precise information and allow market authorities to much more easily process disclosed information. This chapter has also recommended that US securities exchanges require corporations to disclose certain information on OMR plans, like in the EU, which would make it easier for the SEC to compare the details of OMR plans with after-the-fact disclosure of OMRs to see whether and to what extent corporations fulfill their plans.

This dissertation has sought to offer a more enhanced disclosure regime but nevertheless disagreed with the pre–repurchase disclosure requirement *per se*, which has been in force in the EU and has been offered by a previous study for the US. The pre–repurchase disclosure requirement, which requires corporations to disclose details of each OMR program just before the start of trading in a program, has more certainty and credibility than OMR announcements. Such certain and credible disclosure is likely to increase the share price prior to the start of trading in an OMR program that would compel corporations to repurchase their own shares at an inflated price and alleviate the risk of indirect insider trading. However, such an increase in the share price would increase the ability of those having superior information to sell their own shares at the inflated price. More importantly, the pre–repurchase disclosure requirement would also make OMRs resemble repurchase tender offers and cause another problem to occur that is associated with repurchase tender offers. Accordingly, a corporation's purchase of its own shares at an inflated price would not only reduce insider profits that could be reaped from indirect insider trading but also harm the corporation and thereby its non–selling shareholders. Alternatively, the corporation may decide not to repurchase its own shares at a premium, in which case the OMR program will fail.

Instead, this dissertation has suggested that the SEC must require corporations to timely disclose their OMR activity after-the-fact. In the US, corporations are required to report their monthly OMR activity to market authorities in quarterly and annual reports. Hence, this dissertation has agreed with a previous proposal that the SEC should require corporations to disclose their trading activity within two business days, just like the trade-disclosure rule of the SEC that requires insiders to disclose their trading activity within two business days. In the EU, corporations are required to report and disclose each OMR transaction no later than by the end of the seventh daily market session following the date of the execution of the transaction. This chapter has proposed that the EU may also consider shortening the seven-day rule. Additionally, this chapter has proposed that both US and EU market authorities require corporations to disclose the purpose of each OMR transaction without exclusively listing legitimate purposes, for which OMRs can be executed. Most importantly, this chapter has proposed market authorities to require corporations to include in their detailed statements as to why they have the specified purpose and why they prefer OMRs over other viable alternatives, if any, in accomplishing the specified purpose.

More rigorous and timelier disclosure regime might enable market authorities to more effectively monitor OMRs and enforce anti–manipulation provisions and insider trading rules, if necessary. Hence, this dissertation has made another proposal in that market authorities on both sides of the Atlantic must increase oversight on OMR activity through establishing a distinct division or increasing the capacity of their existing divisions. Such division would review each corporate disclosure regarding OMRs by putting OMRs to a unified test in the light of information provided in the enhanced disclosure regime, the compliance levels of OMR programs with trading conditions (and trading restrictions in the EU), and the level of information provided as well as the content of such information, and compares the OMR activity of corporations with insider trades around OMRs disclosed pursuant to trade-disclosure rules. With this particular proposal, this dissertation seeks to deter corporations from excessively executing OMRs by increasing the probability of legal action that those engaging in market manipulation and insider trading would face.

This chapter has also made a number of proposals that would complement the main proposals to increase oversight on OMRs and enhance disclosure requirements. First, in addition to the existing trade-disclosure rules for insiders as well as the above-proposed disclosure requirements on OMRs, this chapter has recommended that the SEC require corporations to disclose, if any, information on trading restrictions imposed by corporations that would restrict themselves from selling and their insiders from trading during OMR programs along with the post–repurchase disclosure requirement. Such disclosure would enable the SEC to take into consideration as one of the factors in its review process whether corporations impose trading restrictions on themselves and their insiders with respect to OMRs, and whether and to what extent these trading restrictions are complied with. Second, this chapter has also recommended both US and EU corporations to offer dividend protection to executive stock options, which would insulate the options from negative changes due to dividend payments and incentivize managers to prefer dividends over OMRs. More importantly, market authorities must require corporations to disclose information on corporate policies regarding dividend-protected stock options. While dividend protection gives insiders a privileged right to protect the value of their stock options, the third proposal seeks to offset this privilege and prevent managers from making short-term profits via executive stock options. To that end, the third complementary recommendation has suggested the SEC to revise the legal status of executive stock options in the context of the trade-disclosure rule and advising all market authorities both in the US and the EU to pay closer attention to executive stock options exercised and shares sold around OMRs. The fourth complementary proposal has recommended debtholders both in the US and the EU to make sure that they have covenants in place that would restrict corporations from using debt to finance unanticipated repurchases. Lastly, this chapter has recommended US and EU market authorities to educate shareholders specifically on OMRs and generally on their cognitive biases that would affect their investment decisions including those on OMRs with the hope of inducing them to more closely monitor the OMR activity of corporations and initiate private enforcement, or at the least, to make more informed decisions on OMRs.

This chapter has concluded with an analysis of the costs and benefits of all the proposals. First, potential costs associated with the implementation of the proposed amendments to the existing disclosure regimes would be trivial since they are compatible with the main organizing principle both in the US and the EU. On the other hand, this chapter has acknowledged that these proposals would increase costs associated with making more rigorous and timelier disclosures for corporations so that managers would have to be more prudent in their repurchasing decisions, which might also result in the reduction of the number of OMRs. That is to say, an increase in costs would serve the purpose of this dissertation of curbing OMR activity that would partly eliminate the potential drawbacks arising from the excessive use of OMRs. Second, this chapter has acknowledged that the recommendation to increase oversight on OMRs could bring some costs to be borne by market authorities. However, the deterrence effect of increased oversight (along with that of the enhanced disclosure regime) would be expected to reduce these costs by substantially reducing the number of OMRs that need to be reviewed by market authorities. Finally, complementary proposals have in general little or no cost associated with them. Self-imposed trading restrictions on corporations and corporate insiders might insignificantly reduce liquidity during certain periods; costs arising from the accounting treatment of dividend protected stock options as variable-plan options would not be prohibitively costly; making a reinterpretation or a minor amendment to the short-swing profit provision would not be too costly for the SEC; and further educating shareholders would create an insignificant expense on market authorities. On the other hand, these complementary proposals are expected to substantially decrease the number of OMRs while partly increasing the use of alternatives led by (regular and special) dividends, which provide much less incentive for those having superior information to engage in manipulation and informed trading.

CHAPTER V. CONCLUSION

A. Dissertation Summary

The beginning of the dramatic increase in the number of OMRs in the US coincides with the (de)regulation of OMRs in 1982, however, the increase has been mainly due to corporate changes at the time. These changes as well as the deregulation policy have been the corollary of the resurgence of economic liberalism in the wake of the alleged ineffectiveness of the US economic and corporate structure against global competitive pressures. In parallel with neoliberal economic policies, economists developed a new corporate theory, which is colloquially known as shareholder value theory. This theory hypothesizes shareholders as the owners of corporations and managers as their agents so that managers have the duty to maximize shareholder value. However, managerial interests may differ from those of shareholders and the difference in interests within the agency relationship translates into added costs, namely, agency costs. Agency costs include monitoring costs that are borne by shareholders. In order to mitigate agency costs, shareholder value theory, by assuming that corporate interests are best aligned with those of shareholders, favours policies that would align the interests of managers with those of shareholders.

One of these policies has been OMRs that would mitigate agency costs by increasing shareholder value while financially benefitting managers. More specifically, OMRs mitigate agency costs and increase shareholder value by enabling corporations to more efficiently distribute excess cash to shareholders in certain circumstances. OMRs also have a complementary relationship with stock-based executive compensation, which seeks to mitigate agency costs by incentivizing managers to increase shareholder value. In addition, OMRs enable managers to facilitate corporate finance in a way to mitigate agency costs and increase shareholder value. Simultaneously, the takeover-deterrent effect of OMRs, creates another incentive for managers to execute OMRs. Lastly, OMRs enable corporations to supply shares to meet their obligations arising from employee share ownership plans, which are crucial schemes in systems with weak employee participation rights. Hence, this dissertation has suggested that the multifunctionality of OMRs in the Anglo-American economic and corporate context accounts for the large part of the increase in the number of OMRs.

However, this dissertation has also found that the purported benefits of OMRs have been overstated and fail to fully explain the dramatic increase in OMRs, and that illegitimate purposes might have also contributed to the increase in the number of OMRs. OMRs are open to abuse because OMRs (both OMR announcements and actual OMRs) inflate share prices since OMRs increase market demand by signalling that corporations have excess cash that would be distributed to shareholders. In addition to the information signaling effect, actual OMRs also increase share prices by allowing corporations, in the case of downward-sloping stock demand curves, to repurchase their own shares at a discount from shareholders, whose share valuation is low. By doing this, actual OMRs also increase EPS as they decrease the number of outstanding shares. Moreover, the non–obligatory nature of OMR announcements may enable those having superior information to engage in false signalling, whereas the combination of the bargain and disproportionate nature of actual OMRs may enable those having superior information to exploit OMRs at the expense of selling shareholders.

Furthermore, once authorized by the board in the US, managers are solely and exclusively authorized to execute these potentially manipulative transactions, while they are able to trade their own shares and exercise their stock options. Consequently, the combination of the inflationary and non–obligatory nature of OMR announcements and the inflationary, bargain, and disproportionate nature of actual OMRs makes them susceptible to be used as manipulative tools by managers with the intention of engaging in insider trading. The potential for market manipulation and insider trading is also acknowledged by the SEC. However, rules prescribed by the SEC have been ineffective in that mandatory disclosure requirements are neither detailed nor timely, the non-exclusive safe harbor rule only sets forth guidelines for corporations and is not directly enforceable, and insider trading rules are not easily enforceable. Consequently, there have been no known OMR-related lawsuits in the US since the adoption of the Rule 10b-18. Thus, this dissertation has agreed that managers are able to engage in market manipulation and insider trading via OMRs and exploit them at the expense of less-informed shareholders.

On the other hand, shareholders have been given greater power with the expectation of having shareholders effectively monitor managers. However, institutional shareholders are able to enjoy their power and, in the assumption of fixed cost of information acquisition, they have access to more information than retail shareholders. Yet institutional shareholders inherently hold larger stakes and have more financial resources than retail shareholders that enable them to suffer less from rational apathy and to more actively monitor management. Thus, active institutional shareholders having access to more information than retail shareholders are able to exploit actual OMRs due to the manipulative and disproportionate nature of OMRs. Moreover, active institutional shareholders typically hold shares, the percentage of which would be less than the threshold that would subject them to rules applicable to insiders. As a result, this dissertation has argued that, although to a lesser extent than managers having access to inside information, active institutional shareholders hold informational advantage that enables them to exploit OMRs at the expense of less-informed shareholders.

This dissertation has also claimed that the ability of both managers and active institutional shareholders to exploit OMRs causes their interests to be aligned with respect to OMRs. Indeed, some active institutional shareholders, particularly hedge funds whose investment horizons have been shorter than other investors, not only actively monitor management but also pressure managers to make business decisions that favor their short-term financial interests. In this context, short-term shareholder activists would pressure managers to execute OMRs that would increase shareholder value mainly by inflating share prices and other business metrics in the short-term. On the other hand, the vast majority of executive compensation comprises of stock options and stock awards that are tied to share price and EPS targets to be reached in quarterly financial reports. Thus, managers would have financial incentives to align with short-term shareholder activists with respect to OMRs, which inflate these performance metrics in the short-term and enable managers to entitle to stock options and stock awards. Hence, this dissertation has been one of the few studies that have clearly articulated that the interests of managers and short-term shareholder activists have been aligned with respect to OMRs.

The alignment of interests of managers with those of short-term shareholder activists with respect to OMRs might cause corporations to excessively execute OMRs that would result in underinvestment. OMR-induced underinvestment would ultimately harm corporations and thereby all corporate stakeholders including but not limited to long-term shareholders, employees, households under the capacity of consumers and taxpayers, and creditors. Hence, this dissertation has argued that the ineffectiveness of the rules on these manipulable market transactions is likely to cause managers and active institutional shareholders to exploit OMRs to enrich themselves at the expense of less-informed shareholders and harm markets.

Prior to making policy and regulatory proposals on OMRs in the US, this dissertation has compared and contrasted the regulation on OMRs as well as purported benefits of OMRs and potential drawbacks that could arise from the abuse of OMRs in the US with those in the EU. EU Member States traditionally took a prohibitive approach on share repurchases that was quite the opposite of the permissive approach in the US. However, share repurchasing regulation in EU Member States and later the EU has converged towards the US following from globalization since the 1980s. The convergence concerning share repurchasing regulation has been part of the wider liberalization process in the EU, the objective of which was to attract foreign investors to invest in the EU market. Foreign investors entered into the EU market primarily through the privatization of formerly state-owned large EU companies. The introduction of US-style investors and investment methods through share issue privatizations stimulated shareholder capitalism that activated markets and increased financialization. Consequently, OMRs, as financial tools executed on the open market, have also been (de)regulated, like in the US. This finding has also contributed to the convergence debate in that the regulation on OMRs in the EU has substantially converged towards that in the US, with the exception of a few regulatory technical differences.

Following this convergence, the number of OMRs has also increased in the EU. Notwithstanding that the increase has been even more rapid than that in the US, the increase has emerged more recently and the number of OMRs has been lower compared to the US. Moreover, the OMR activity has been concentrated in the hands of a few companies in a few EU Member States, particularly in the UK and France. These privatized companies bear the traces of Anglo-American corporate model, in which ownership is relatively dispersed and thus separated from control. Hence, agency relationship emerges between shareholders and managers so that managers assume the duty to maximize shareholder value. In this context, OMRs appear as beneficial tools, which explain the increase in the number of OMRs in the EU. Hence, the comparative approach of this dissertation supports that the OMRs have been particularly beneficial in the Anglo-American economic and corporate model. On the other hand, most EU companies still adhere to the Continental European economic and corporate model, in which OMRs are not needed as much as in the US. The persistence of underlying institutional settings has also explained why the number of OMRs has been lower than that in the US.

Institutional differences that remain in place between the US and the EU also provides compelling explanations for why technical differences have emerged between the regulatory approaches to OMRs in the US and the EU. These technical differences have been the basis of this dissertation while making policy and regulatory proposals particularly for the US by taking lessons from the EU. However, this dissertation has also made a few proposals for the EU. This is because OMRs can theoretically be exploited by the managers and active institutional shareholders of certain EU companies, and short-term shareholder activists may pressure managers into pursuing corporate transactions, including OMRs that inflate share prices and EPS in the short term. Hence, this dissertation has also criticized the EU and its member states for adopting a rule that is essentially the same as the ineffective rule in the US by disregarding idiosyncratic institutional structure of their system and making compromises from their regulatory principles for the sake of attracting foreign investment. For this reason, this dissertation has made various recommendations both for the US and the EU by comprehensively comparing the weak and strong features of their regulatory framework on OMRs.

In order to prevent those having inside (and superior) information from exploiting OMRs and eliminate the potential drawbacks arising from the abuse of OMRs while maintaining the benefits of OMRs, this dissertation has come up with two major regulatory proposals. First proposal has been the recommendation to market authorities to enhance their existing disclosure regime. Accordingly, since the authorization to execute OMRs is given to managers by the board of directors in the US, this dissertation has advised US corporations to give the authorization power to disinterested (and independent) directors only. Similar to the EU, this dissertation has also suggested that US corporations give shareholders the right to an advisory vote on repurchase authorizations to be given by the board for a finite period of time at the general meeting. Additionally, it was proposed that securities exchanges require corporations to disclose, if any, more information on the advisory voting process along with the announcement of authorization on OMR plans. It has also been suggested that securities exchanges in the US require corporations to determine and announce the details of OMR plans. This dissertation has also recommended that the EU (and also the US in case the former proposal is implemented) require corporations to specify a short(er) authorization period, preferably no more than a financial year.

On the other hand, this dissertation has disagreed with the pre–repurchase disclosure requirement that has been in force in the EU and has been proposed for the US. Such disclosure requirement might substantially inflate share prices prior to the start of OMR program and pose many other problems while attempting to eliminate the potential of indirect insider trading via OMRs. Rather, this dissertation has supported a previous proposal that recommends the SEC to require corporations to disclose details of actual OMRs shortly after their execution, like in the EU. The more detailed and timelier ex post disclosure regime might inhibit corporate decision makers from excessively executing OMRs. This is because such regime would increase the time and cost needed to fulfill the disclosure requirements and increase the possibility of detection of market manipulation and unlawful insider trading by market authorities. Hence, the second major proposal has been that market authorities must increase their oversight mechanisms through hiring new staff for existing compliance/oversight divisions or organizing a new division responsible for putting each and every OMR transaction to a unified test after-the-fact. While such proposal would increase the cost to be borne by market authorities, the cost would be less than anticipated. Yet, both of the proposals made by this dissertation would have the effect of deterring corporations from excessively executing OMRs so that the number of transactions that need to be reviewed by market authorities would decrease.

This dissertation has also made a number of complementary proposals that would have the effect of reducing the number of OMRs by deterring corporations from excessively executing OMRs or by incentivizing managers to choose alternative methods, including but not limited to dividends. The rationale here is that alternative methods that fulfill functions of OMRs would provide much less opportunity for those having superior information to engage in market manipulation and insider trading while incurring less significant costs on market authorities. To this end, this dissertation has recommended market authorities, particularly the SEC, to require corporations to disclose, if any, information on trading restrictions imposed by corporations that would restrict themselves from selling and their insiders from trading during OMR programs. The disclosure of this information would enable market authorities to take the presence and the enforcement of such self-regulation into consideration as one of the factors in its review process. This dissertation has also made a proposal for both US and EU corporations to offer dividend protected stock options to managers. This proposal would be expected to incentivize managers to prefer dividends over OMRs at least in cases dividends are more efficient than repurchases. This dissertation has also recommended that market authorities require corporations to disclose information on their policies with respect to dividend-protected stock options. While dividend protection grants executives the privilege to protect the value of their stock options, this dissertation has made a recommendation specifically to the SEC to reinterpret or revise the legal status of executive stock options in the context of the short-swing profit provision in a way to prevent managers from making short-term profits via executive stock options. This dissertation has also recommended debtholders both in the US and the EU to make sure that they impose covenants that would inhibit corporations from debt-financing OMRs that could not be anticipated by debtholders. Finally, this dissertation has suggested that US and EU market authorities should further educate shareholders not only on OMRs but also on their cognitive biases to enable them to make more informed decisions including but not limited to OMRs, if not inducing them to more closely monitor the OMR activity of corporations and initiate private enforcement.

B. The Bigger Picture

The main research method of this study, i.e., comparative legal research, has enabled this dissertation to contribute to the convergence-divergence debate with respect to corporate law. This dissertation has determined that rules applicable to OMRs (as part of legal capital and market rules) in the EU have substantially converged towards those in the US. Such legal convergence has occurred as a result of the adoption of the liberal approach of the US by the EU. The liberal approach typically gives corporations wide discretion to use OMRs, which are financial tools that could be beneficial for corporations and certain corporate stakeholders when executed under certain circumstances. For this reason, initially some EU Member States and later the EU has adopted rules essentially similar to the safe harbor rule in the US.

On the other hand, this study has also articulated reasons for why market authorities within the scope of this research regard OMRs as transactions that are prone to be used for market manipulation and insider trading. Additionally, this dissertation has argued that the safe harbor rule primarily in the US and also in the EU has turned out to be ineffective in eliminating the potential drawbacks that could arise from the abuse of OMRs. Thus, the adoption of the US safe harbor rule by the EU might theoretically cause these potential drawbacks to occur in the EU as well.

However, this dissertation has also found out a few regulatory technical differences that have caused the OMR regulation in the EU to remain slightly stricter than that in the US. More importantly, this dissertation has argued that the less frequent use and the low probability of abuse of OMRs in the EU in comparison with the US has been mainly due to the persistence of the Continental European economic and corporate model and the resilience of institutions within this model, which also induced the regulatory technical differences. Indeed, this dissertation has demonstrated that most EU companies persist in the Continental European model, in which OMRs are not as much needed as in the Anglo-American model. That is, OMRs are financial transactions that are beneficial particularly for shareholder-oriented corporations operating in highly financialized markets only when executed under certain circumstances. EU companies, however, are more stakeholder-oriented and their main source of finance is banks.

In this respect, this study has also contributed to the discussion of shareholder-stakeholder debate. Regardless of the ineffectiveness of safe harbor rules on both sides of the Atlantic, the dominance of companies with Continental European model in the EU seems to have substantially prevented the potential drawbacks associated with the abuse of OMRs to occur in the EU. Rather, the prevalence of companies with Anglo-American model, namely shareholder-oriented corporations financed by securities markets, exacerbates the potential drawbacks associated with the abuse of OMRs. Yet, as this dissertation has argued, OMRs have a number of benefits from a shareholder point of view, whereas OMRs might also be simultaneously exploited by more informed shareholders at the expense of less informed shareholders.

The potential of exploitation of OMRs would also cause certain corporate actors to align their short-term financial interests with respect to OMRs. Such alignment of private interests might result in the excessive use of OMRs which would harm corporations (and corporate stakeholders including long-term shareholders) by causing underinvestment. Hence, this study has provided another tangible evidence for previous line of research that criticizes shareholder value theory based on the claim that shareholders of US corporations, which are characterized by dispersed ownership structures, have divergent and even conflicting private interests, and the pursuit of private interests might contradict with common shareholder interests as well as interests of corporations.

In conclusion, this dissertation has made major contributions to the relevant literature by drawing insightful conclusions with respect to OMRs. Accordingly, many countries tend to adopt liberal rules that cause them to converge towards the Anglo-American model of corporate governance. On the other hand, most countries continue to diverge along path-dependence trajectories as institutional configurations remain largely intact. These configurations happen to be effective in averting the potential drawbacks that could arise from the abuse of certain corporate practices. More specifically, notwithstanding that EU Member States (and other countries) tend to converge towards the US by transcribing liberal rules that allow for the use of certain corporate practices but fail to eliminate the potential drawbacks associated with these practices, Continental European corporate model largely persists and substantially reduces the potential of these drawbacks in the EU. For this reason, this study supports recent efforts made in the US to replace shareholder value theory with a more inclusive theory that would also effectively restrain corporate constituents to exploit corporate practices,[740] like in the EU.

C. Future Remarks

Just as the amendments to the Rule 10b-18 in 2003 that provided more lucid insights into the OMR activity of corporations in the US by enhancing the disclosure regime, one of the two main

[740] For a more recent statement in a similar vein, *see* BUS. ROUNDTABLE, STATEMENT ON THE PURPOSE OF A CORPORATION, (2019), *available at* http://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

proposals of this dissertation has been to further enhance the existing disclosure regime. The enhanced disclosure regime would provide much more information on OMRs that would be of much help for future research on OMRs. If future research reveals that the policy and regulatory proposals of this dissertation, once implemented, also fail to eliminate the drawbacks that could arise from the abuse of OMRs, then it will have proven time to reconsider other policy proposals. One of these policy proposals might be to enact a prescriptive rule that would impose substantive requirements on repurchasing corporations like the rules proposed before the adoption of Rule 10b-18 in the US as well as similar substantive rules elsewhere, that have been briefly reviewed and found to be much more radical than the proposals made by this dissertation. In line with the ongoing research on traditional OMRs, another advise for future research would be to study on other related financial tools such as pre–set OMRs and at-the market issuances, which would also have the potential to be exploited by those having inside or superior information.

On the other hand, even if the above proposals were implemented and found to be successful in reducing the abuse and the excessive use of OMRs, these proposals do not address the more general problem, which has been the short-term thinking. Rather, this study specifically addresses potential drawbacks that could arise from the abuse of OMRs, namely the use of OMRs to extract value in the short-term and the consequent excessive use of OMRs that would cause underinvestment. Thus, although to a much lesser extent, managers and shareholders having short-term financial interests would be able to continue to follow short-term strategies including the distribution of cash to themselves in the form of (regular and special) dividends instead of OMRs even after the implementation of the proposals made by this dissertation. Notwithstanding the distribution of cash via dividends would be open to exploitation much less than the cash distributions via OMRs, distribution of too much cash in any payout method will continue to inhibit corporations from operating innovatively and growing sustainably, and thereby have major long-term consequences on many corporate constituents.

Hence, this dissertation generally advises economy scholars to revise the economic theory of corporations that contradicts with the legal corporate theory as well as the social reality. More specifically, the advice for the future would be that US corporations act upon a corporate model shaped by a theory that is more inclusive and less incompatible with the corporate legal theory. An example model would be the enlightened shareholder value as in the UK that requires directors to act in a way to promote the success of the corporation for the benefit of its members as a whole while having regard to the likely consequences of any decision in the long term as well as to the interests of employees, suppliers, customers, and to the impact of operations on the community and the environment.[741] On the other hand, EU Member States and companies should continue to persist with the stakeholder theory after dispelling misperceptions on the liberalization and privatization based on the unfounded claim that the Anglo-American economic and corporate model is superior to the Continental European economic and corporate model. In tandem with such potential changes in the corporate theory, the managerial ideology, the role of labor in corporate governance, and the share ownership structure as well as corporate rules and practices through proxy advisory firms that exacerbate the short-term thinking and the excessive use of OMRs, including but not limited to stock-based pay and quarterly financial reports, must be reviewed particularly in the US in the light of lessons that could be drawn from the Continental European

[741] *Id.*

economic and corporate model as well as the most recent amendments to directives and regulations in the EU.

This dissertation has also found that global and national competitive pressures have also contributed to short-termism by setting off a typical race to the bottom, in which corporations in the US and later in the EU steered toward an ever-more shareholder-centric model. Hence, this dissertation recommends both the US and the EU governments and policymakers to fight against shareholder populism that comes with the "shareholder democracy", by taking necessary measures to disincentivize managers and shareholders to solely have short-term financial interests and encourage long-term shareholders to more actively participate in the corporate governance. Ultimately, this dissertation also invokes international organizations such as World Bank and International Monetary Fund, which once promoted the Anglo-American economic and corporate model based on its purported superiority, to be much more diligent in making worldwide recommendations. This dissertation recommends these international organizations to acknowledge and consider the path-dependence trajectories of national economic and corporate systems in each jurisdiction based on their inherent structural differences embedded in their cultural, political, economic, and legal structures, and consider these differences and make tailor-made recommendations rather than one-size-fits-all recommendations.

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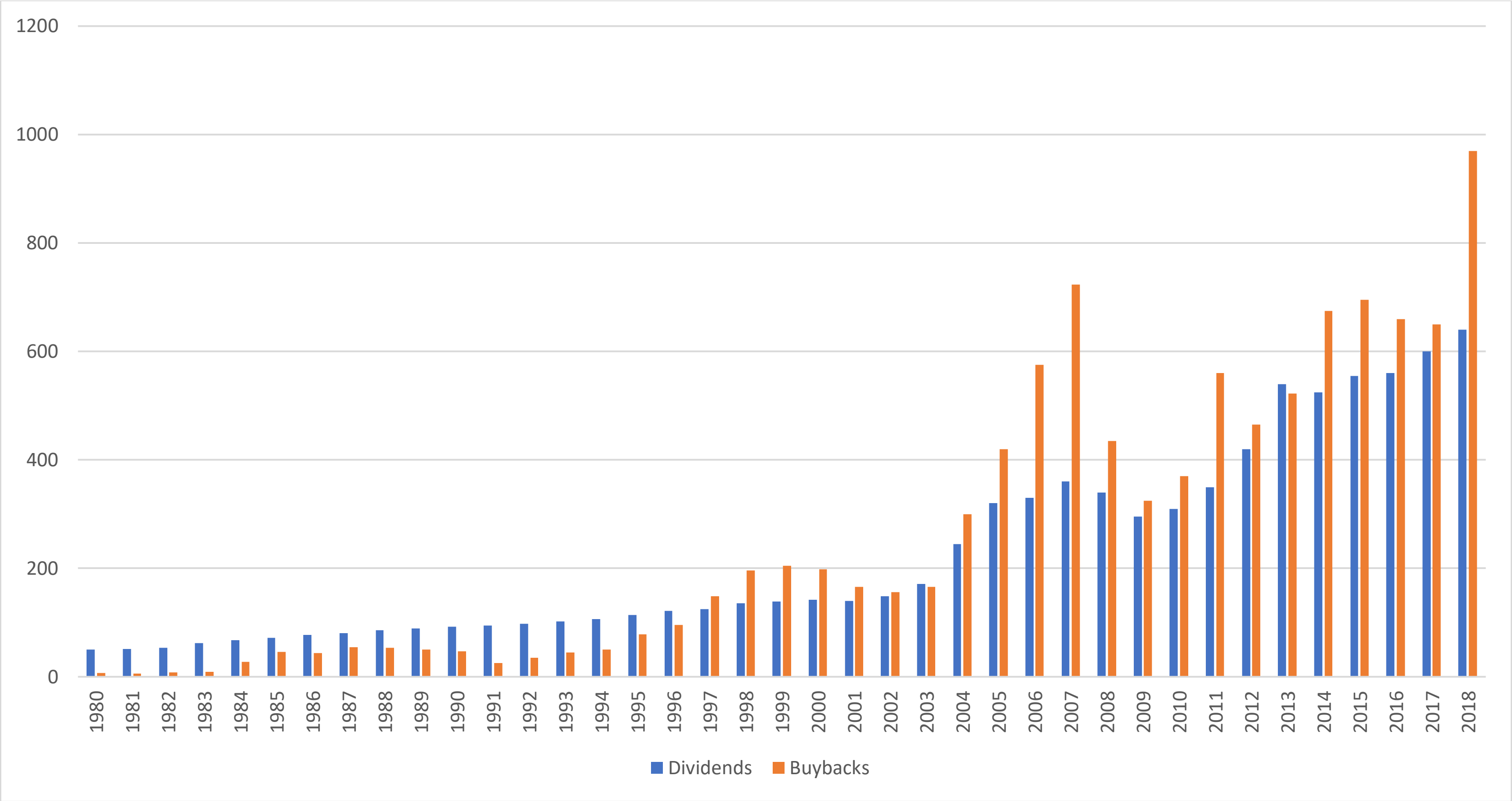
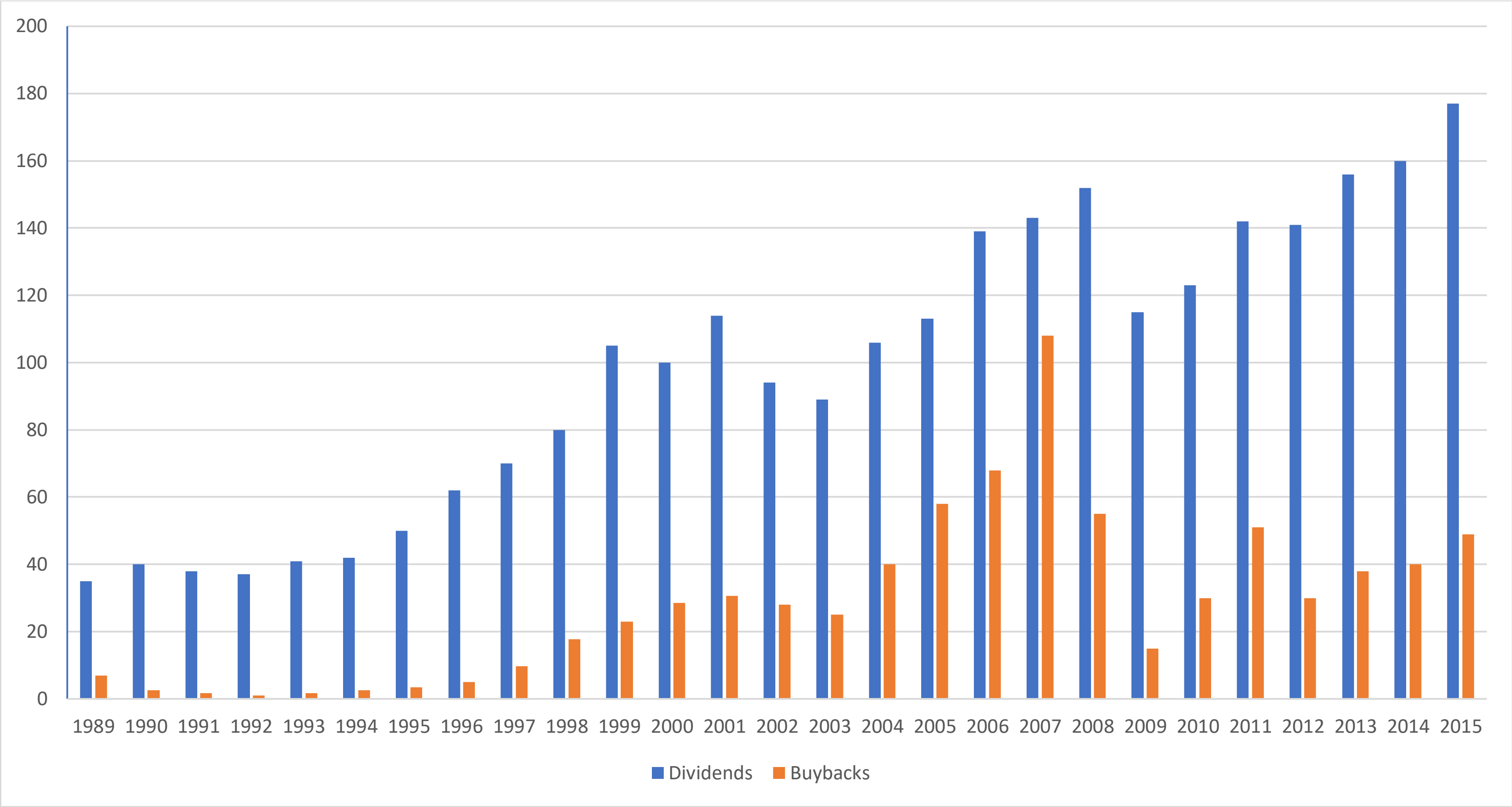
APPENDICES

Appendix 1: Aggregate Dividends and Buybacks Executed by Certain Listed Corporations in the US, in $ billions, 1980-2018



* This chart is the reproduction of the chart prepared by Zeng and Luk (2020), who have collected data from S&P Dow Jones Indices LLC, Compustat for certain companies listed in US securities markets for the years between 1980-2018. Data may include the amount paid for preferred shares. Notwithstanding that a great majority of buybacks has been in the form of open market repurchases, the buyback data above may include shares bought back through other repurchase methods. This chart is provided only to illustrate macro trends on buybacks in comparison with dividends within the stated place and time period.

Appendix 2: Aggregate Dividends and Buybacks Executed by Certain Listed Companies in the EU 15, in € billions, 1989-2015



* This chart combines data collected by Eije and Megginson (2008), who have collected data for the years between 1989-2005, and Sakinç (2017) that has collected data for the years between 2000-2015. While the former research includes the listed industrial companies in the EU 15 (Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom), the latter includes 298 companies in the S&P Europe-350 Index in the EU 15 (including Norway instead of Greece) and Switzerland. This chart, however, excludes Switzerland since it has not been a member of the EU and thus not subject to the EU legislation on repurchases and has had a dividend and buyback activity that significantly differs from the rest of the countries included in the sample. Data may include the amount paid for preferred shares. Notwithstanding that a great majority of buybacks has been in the form of open market repurchases, the buyback data above may include shares bought back through other repurchase methods. This chart is provided only to illustrate macro trends on buybacks in comparison with dividends within the stated place and time period.