Share repurchase by quoted companies

In the immediate aftermath of last October's stock market crash, some 650 American companies announced share repurchase programmes. Even though in most cases the volume of purchases under these programmes may have been nugatory, it seems likely that the announcements themselves exerted a steadying influence on share prices. In the United Kingdom, by contrast, there was no significant increase in share repurchase proposals by companies. This paper[1] *examines the rationale for share repurchases and the legal and taxation framework which governs them in the United Kingdom. Comparisons are drawn with the regimes in the United States and elsewhere. The paper concludes by suggesting that company managements and shareholders in the United Kingdom should be more prepared than hitherto to give consideration to share repurchase as a possible component of companies' financial strategy.*

Rationale

There are several arguments cited in favour of company share repurchases. In sum, these are that they provide a means by which a company can:

- return surplus cash to shareholders;
- increase the underlying value of its shares;
- support its share price during periods of temporary weakness;
- achieve or maintain a target capital structure;
- prevent or inhibit unwelcome takeover bids.

These arguments are examined in detail in the following paragraphs.

Surplus cash

This argument rests on the proposition that if a company has no projects with a positive net present value in which to invest, it has the alternative of leaving spare cash on deposit or returning it to shareholders. If shareholders have uses for the funds (including investing in the shares of other companies) which yield a risk-adjusted return in excess of the rate of interest earned by the company, then it is to their advantage, as owners of the company, to have the cash returned to them. A number of points arise in elaboration of this simple argument.

In the first place, there is a question whether having a high level of liquid assets might tempt companies into financing business investments that they would find difficult to justify if they had to rely on external sources of funds. In certain cases, it is argued, companies may thereby obtain a worse return than would be generated by leaving their cash on deposit, and, *ex hypothesi,* than shareholders could earn elsewhere. That such irrational behaviour takes place on any significant scale is unlikely; but, in so far as excess liquidity does prove a temptation to company managements, there would seem to be merit in reducing obstacles to its distribution to shareholders.

A related point is whether the interests of the company should be regarded as identical with those of its shareholders. Specifically, the argument runs that the aspirations of a company's managers may not always coincide with those of its shareholders. For example, managers may prefer to see their companies grow even if the marginal rate of profitability is brought to a lower level than shareholders could obtain elsewhere. Indeed, for many managers the idea of returning cash to shareholders on the grounds that they can see no prospect for using it profitably within the business—or for purposes of expansion or diversification—would appear to be tantamount to an admission of managerial failure.[2] If so, simply facilitating the distribution of surplus cash to shareholders may not be enough: what is required is a change in managers' attitudes, and this in turn may require a change in investors' attitudes.

A third issue is whether it is more appropriate to distribute surplus liquidity to shareholders by means of higher dividend payments than through repurchases of shares. In theory, the choice should depend on whether the surplus cash arises from a continuing source (in which case dividends would be the appropriate method of distribution) or from a once-off occurrence. There are also other factors to be taken into account. Leaving aside the influence of taxation, the dividend route has the advantages that it does not entail additional administrative expenses and that all shareholders are treated with transparent fairness and even-handedness. Share repurchases, on the other hand, will incur transactions costs and, when market transactions are

(1) This paper has been prepared by the City Capital Markets Committee. Set up in 1980, the Committee is one of a number of specialist committees formed at the initiative of the Bank. Its terms of reference are: 'To act as a focal point within the City for views concerning current issues and future developments, including Company Law matters, which affect the domestic and international capital markets in the City.'

(2) Similar arguments could in principle be adduced in respect of dividend payments. But, apart from the fact that shareholders will generally prefer some cash flow from their shares and not just an appreciation of their capital value, dividends also perform a particular signalling role (discussed below).

involved between a company and some, but not all, of its shareholders, it may be more difficult to satisfy everyone concerned that they have been treated even-handedly. (If selective, non-market transactions are also involved, problems of this kind will be compounded.) Against that, it could be argued that shareholders are given the choice as to whether to accept a share repurchase offer, whereas they do not have any option in the case of dividend distributions.

There is a further counter-argument to using the dividend route derived from the notion that dividends are an important means by which companies transmit signals to their shareholders. Quite simply, increasing the dividend in order to return surplus cash to shareholders, perhaps over a number of years, can give the impression of an improvement in profitability, when the reason for the distribution may in fact be the absence of profitable opportunities. The company can of course try to make clear to its shareholders how much of the payment represents a return of accumulated cash and how much represents a normal dividend; or it could pay a special dividend. But in either case the underlying rationale may soon be forgotten and is anyway not readily apparent from published dividend yields, price-earnings ratios, and so forth. The method of share repurchase, by contrast, is less likely to provide misleading signals.

A final factor which is relevant to the choice between dividend payments and share repurchase is the impact of taxation. The broad provisions are set out in Appendix 1. In general, the effect of the relevant legislation is to ensure that, from a tax point of view, the purchase by a company of its own shares is effectively the payment of a dividend in so far as the cash paid out exceeds the capital actually subscribed for those shares. In principle, therefore, the tax regime is neutral as between dividend payments and share repurchases. In practice, however, there are different modalities of share repurchase—market purchases, direct off-market purchases from individual shareholders through private treaty, or general tender offers—and companies have different shareholder profiles, ranging from gross funds, which pay no tax, to private individuals, who are subject to income tax and capital gains tax. The interaction of these factors can make dividend payments more or less efficient than share repurchases from the point of view of different shareholders depending on the precise circumstances. It is not possible to generalise, therefore, and all that can be said is that tax factors may influence a company's decision on whether, and if so how, to distribute surplus cash through the medium of share repurchases.

Despite this, it is an observed fact that most share repurchases are effected through market purchases (probably because this is the simplest route). This method involves a tax asymmetry. Companies attract advance corporation tax (ACT) liability, but shareholders are normally treated as making a capital gain, and are subject to capital gains tax according to their personal circumstances. As with normal dividend distributions, a company with, for example, a large proportion of its income derived from overseas may be unable to recover all its ACT payments because its mainstream corporation tax liability is insufficient.

Increasing the underlying value of shares

The argument is usually couched in terms of the impact on net asset value per share or earnings per share. If a company repurchases some of its shares at a discount to net asset value per share, the latter will obviously rise. Equally, if the earnings yield, calculated at the repurchase price, is greater than the cost (in terms of income forgone) of financing the repurchase, then earnings per share will rise.

Whether or not share repurchase leads to an increase in share price depends on a variety of factors. The market may, for example, be disappointed that the company has no profitable use for its spare liquidity, and hence mark the share price down on these grounds; on the other hand, the impact on the company's gearing (on which see also below) may be perceived by the market as advantageous to future dividend prospects.

Supporting the share price

As already indicated, the use of share repurchases to support share prices has become topical following the series of share repurchase announcements by major US companies which contributed to a revival in investor sentiment on Wall Street in the wake of last October's crash. The impact on share prices may reflect an announcement effect as well as an actual increase in demand. If this strategy is to be successful, it is necessary for the company to be able to identify a period of *temporary* price weakness. If a company gets things badly wrong (repurchases followed by a further significant fall in the share price), it must expect strong criticism from continuing shareholders. On the other hand, if the operation is apparently too successful (repurchases followed by a significant rise in the share price), sellers may be discontented.

The more general point is that company managements have a general tendency to consider that their shares are undervalued, and so will have a bias towards supporting their share prices through repurchase. It is useful to distinguish between circumstances in which there is a general fall in share prices, and those in which an individual company's share price falls in isolation or relative to others in the same sector. In the latter case, it is unlikely that share repurchases will have a long-lasting effect unless they prompt the market to reassess publicly available information relating to the company; in which case there is a question of whether the company should embark on an education campaign in preference to repurchasing its shares. If, however, the whole market is temporarily depressed, the weakness of the company's share price may not be amenable to treatment by this alternative means.

In sum, therefore, the case for a company's supporting its share price in periods of temporary weakness is probably stronger when there is a general fall in share prices than when its share price alone has been marked down by the market. Where, however, it is possible to identify genuine cases of individual undervaluations, US academic studies suggest that share repurchases often have the desired effect. The problem of course is how to identify the genuine cases.

Target capital structure
Companies have views about their desired debt-equity ratios. Without the ability to repurchase shares, a company loses a degree of freedom in adjusting its gearing. In particular, if it wishes to *increase* its gearing, it has to borrow more, since the option of reducing the denominator of the debt-equity ratio (apart from making losses) is denied to it. This seems on the face of it an unnecessary hindrance—geared success (if achieved) is plainly beneficial to shareholders. On the other hand, it may be argued on prudential grounds that it is no bad thing to inhibit companies from increasing their gearing. Moreover, increased gearing and reduced equity decrease a company's borrowing base and may affect its future financial flexibility, cost of funds and credit rating. Whether this is so or not must, however, depend on the circumstances—in particular, the starting level of gearing and the availability of non-borrowed funds.

Protection against unwelcome takeover bids
It is sometimes said that share repurchases can help to thwart predators. With the ability to repurchase, companies are able to buy out disaffected or troublesome shareholders—those who are most likely to sell out to a hostile bidder. By the same token, the percentage ownership of insiders will be increased, again rendering an unfriendly takeover of the company more difficult. Finally, to the extent that share repurchases in the market push up the share price, a hostile bidder may be deterred from proceeding.

The circumstances are rare, however, in which it would be appropriate to use such a technique, and it is not a motive which deserves any encouragement. The risk is that in the majority of instances the practice would be used to inhibit desirable changes in the ownership and management of companies.

In the United States in recent years there has been considerable concern about the activities of 'greenmailers', who buy up large holdings of shares in a company and threaten to sell them on to a hostile takeover-bidder unless the company buys them back itself at an inflated price. This has not been a problem to date in the United Kingdom because the restrictiveness of the regulations surrounding share repurchases has not made this kind of activity feasible, and care is necessary to avoid opening the door to it.

Regulation of share repurchase

This section briefly examines the reasons for restricting companies' freedom to repurchase their shares, and then goes on to describe the regulatory regimes in the United Kingdom and the United States and, in less detail, in a few other industrial countries.

Reasons for restrictions
There are four main reasons which can be regarded as the motivation for restrictions. It is feared that if companies had unfettered freedom to buy back their own shares, they would thereby be enabled to:

- reduce their capital to the detriment of their creditors;
- arrange special off-market deals to the detriment of the general body of their shareholders;
- rig the market in their shares; and
- buy off shareholders who pose a threat to the incumbent management (which would encompass greenmail).

For all these reasons, therefore, share repurchasing has traditionally been circumscribed to varying degrees in different countries.

General methods of regulation
The methods used to limit share repurchasing powers fall into three main categories:

- requirements for prior permission or clearance;
- quantitative restrictions;
- requirements for *ex post* disclosure.

An obvious and flexible method of control is to lay down a general requirement that companies wishing to buy back their shares must obtain *prior permission* from groups whose interests might be adversely affected, or clearance from appropriate regulatory bodies. Well-designed regulations of this kind can be effective against most forms of abuse, without limiting the potential benefits from the use of share repurchase. The main drawback with this approach is that it may be somewhat cumbersome and time-consuming. This disadvantage can, however, be alleviated if the regulations allow companies to seek approval for specific parameters within which share repurchases may be made at the discretion of the Board of Directors.

The most widespread form of *quantitative restriction* consists of a statutory ceiling on the proportion of share capital that can be repurchased within a specified period. While most countries make some use of statutory limits of this kind, the tightness of the constraints imposed shows some variety. This type of control has the advantage that it can be effective in limiting the scope for abuse of all kinds. The corresponding disadvantage is that it also limits the benefits that can be derived from the proper use of share repurchasing powers.

Another common quantitative constraint is a requirement that payments for repurchased shares must be made out of distributable profits. Requirements of this kind are aimed specifically at protecting the interests of a company's debt-holders and creditors.

Another safeguard is to require *disclosure* of details of any share repurchasing activity after the event. Although this may amount to closing the stable door after the horse has bolted, prompt and detailed disclosure can be a useful restraint against most forms of abuse.

Regulation in the United Kingdom

The fundamental principle that the creditors of a company whose shareholders enjoy limited liability should be protected from unauthorised capital reductions has long been established by case law. Thus until 1981 a limited public company was not allowed to acquire its own shares (except that redeemable preference shares could be issued). Following pressure from, in particular, the small business sector, the government commissioned a study by Professor Gower, which was published in the form of a Green Paper[1] in 1980. This was followed by changes in the law in the 1981 Companies Act (which were in line with the provisions of the European Community Second Directive on Company Law). So far as public quoted companies are concerned, the Act allowed them, subject to certain safeguards, to issue redeemable ordinary shares and to purchase their own shares. In order to include the power to repurchase shares in a company's Articles, a majority of 75% of those voting is required. There were also provisions relating specifically to private companies which are not dealt with here. Finally, certain consequential tax changes were introduced in the 1982 Finance Act, but these were largely for the benefit of unquoted trading companies, and the tax regime for listed companies remained basically unchanged (as set out in Appendix 1).

As already indicated, UK quoted companies are now able to repurchase their shares in three main ways:

- by purchases in the stock market;
- by 'off-market' arrangements with individual shareholders;
- through tender offers to the general body of shareholders.

The practice of share repurchase by quoted companies is regulated not only by the Companies Act but also by regulations laid down by the Stock Exchange and the Takeover Panel. The system of controls and safeguards relies mainly on requirements for prior permission from shareholders and prior clearance from the Takeover Panel. These requirements are reinforced by provisions placing quantitative limits on what shareholders can authorise and time limits on the period for which advance authorisation can be given.

In the case of repurchases made through the market,[2] the principal regulatory restrictions and safeguards, using the three main categories listed above, may be summarised as follows:

Prior permission and clearance

(i) A company wishing to repurchase its own shares must obtain prior approval from its shareholders, and also from the holders of any warrants, options or convertible securities. The authority must relate to a maximum number of shares (see (iv) below) and with fixed minimum and maximum prices.

(ii) The authority from shareholders for share repurchase is limited by statute to a period of not more than eighteen months, but the Investment Committee of the Association of British Insurers prefers to see a limit of twelve months.

(iii) Prior clearance must also be obtained from the Takeover Panel, which is concerned with 'control' implications such as the impact on the percentage holding of large shareholders.

Quantitative restrictions

(iv) There are restrictions on the proportion of share capital that can be repurchased through the market in a twelve-month period without further approval from the shareholders. The limit—which is imposed by the Stock Exchange—is 15%. This limit, however, has not been viewed as acceptable by the insurance companies. For some years they imposed an annual upper limit of 5%; earlier this year this was relaxed somewhat, and a figure of 10% now applies. (These restrictions also apply to contracts to repurchase shares, but not to repurchases through partial offers or advertised tender offers.)

(v) Payments for repurchased shares must be made out of distributable profits.

Disclosure

(vi) Details of all share repurchases, including the number of shares purchased and the price paid, must be publicly announced by 12 noon the following day.

(vii) Summary figures, including the total number of shares repurchased and the aggregate consideration, must be published in the company's Report and Accounts.

(1) *The Purchase by a Company of its Own Shares.* Cmnd 7944.

(2) Disclosure requirements for off-market methods of repurchase differ in some details.

Miscellaneous

(viii) As a safeguard against improper use of insider information by companies when repurchasing their shares, the timing of repurchases must conform to the restrictions governing purchases by directors laid down in the Stock Exchange's Model Code. Regard must also be paid to the provisions of the Company Securities (Insider Dealing) Act, 1985.

(ix) All repurchased shares must be cancelled.[1] This reduces the issued share capital but leaves the authorised capital unaffected.

Regulation in the United States

In contrast with the United Kingdom, the regulatory framework in the United States has little emphasis on prior permission or quantitative restrictions. Another important difference from UK practice is that repurchased shares do not have to be cancelled. They may instead be held by the repurchasing company as 'treasury stock', which may subsequently be used for a range of purposes, from employee stock purchase programmes to corporate acquisitions. Such treasury shares are not, however, entitled to dividends or votes.

It might be argued that these two differences are interrelated. Because repurchased shares do not have to be cancelled and can be used for a wide variety of purposes, initial repurchase decisions may often be akin to more or less routine operational decisions and quite unsuitable for adjudication by shareholders. In the United Kingdom, on the other hand, the issues involved in a repurchase decision are narrowly circumscribed and fall within an area in which shareholders might be expected to have at least some claims to competence.

A further difference from UK practice is in the area of *taxation.* So long as share repurchases by a company in the United States are not intended as a substitute for a dividend distribution, they are subject only to tax on capital gains in the hands of the selling shareholders. It is to be noted, however, that the differential between taxes on income and on capital gains has narrowed substantially in recent years.

The main regulatory requirements relating to share repurchase in the United States may be summarised as follows:

Prior permission and clearance

(i) Prior shareholder approval is typically not required, although in exceptional cases a company's charter may require it. Where no authority is required, the Board is free to buy back at above the market price, and on or off the market.

Quantitative restrictions

(ii) Restrictions are imposed under Rule 10b–18 of the Securities and Exchange Commission (SEC) as to the volume, timing, price and manner of purchases, which, if respected, safeguard a company from accusations of share price manipulation. The volume restrictions relate to the proportion of turnover in the shares that may be accounted for by market purchases on any day. There are, however, no overall restrictions on the proportion of share capital that may be repurchased over a period of weeks or months.

Disclosure

(iii) A company wishing to repurchase its shares by way of a tender offer must file a statement with the SEC, and distribute to all shareholders a circular covering the following:

- the source and total amount of funds to be used for the repurchase that are to be borrowed;
- the purpose of the offer, including the ultimate disposition of re-acquired shares;
- any transactions by the company in the same class of securities within the previous 40 days;
- a description of any contracts or understandings entered into by the company in relation to the tender offer;
- certain material financial data and other information pertinent to investors' decisions with respect to the tender offer.

The statement must be filed not later than the opening date for the offer.

(iv) Companies wishing to effect share repurchases through the market are not required to disclose the fact, or the volume of purchases, except according to the criterion of materiality. In other words, there are no specific disclosure obligations in relation to share repurchase through the market beyond the general obligation to disclose material changes in circumstances.

Regulation in other countries

Regulatory arrangements in member states of the *European Community* must be at least as stringent as those contained in the EC Second Directive on Company Law. This requires, in particular, that permission for share repurchases be sought from a general meeting of the shareholders—the period for which authorisation may be given being not more than eighteen months; repurchases may not be made if they would reduce net assets below the sum of capital and undistributable reserves; and authorisation may only be given for repurchases to be made and held of up to 10% of a company's subscribed capital. Repurchased shares do not have to be cancelled, but voting rights are suspended. (The implication of the

(1) English law has traditionally taken the view that it would be wrong for the directors of a company effectively to be able to make a book in the company's shares even if for the benefit of the company.

EC Directive is that repurchases in a period may exceed 10% of a company's subscribed capital if the repurchased shares are cancelled, and this explains why the Stock Exchange rule referred to earlier permits repurchases in excess of that proportion in the United Kingdom.)

The requirement to seek prior permission from a general meeting of shareholders may be waived in two circumstances. The first involves the prevention of 'serious and imminent harm' to the company. Repurchases carried out under this head must be reported to the next general meeting. Second, repurchases for the purpose of distribution of shares to the company's employees do not need prior authorisation; such shares must be distributed within twelve months of their acquisition.

Companies are permitted to buy their own shares in *Switzerland.* In *Japan* the practice is forbidden under the Commercial Code. It is also forbidden in *Australia,* but a change in the law is in prospect which would permit the practice in defined circumstances.

Share repurchasing experience

United Kingdom

As already noted, UK public quoted companies have so far shown little enthusiasm for repurchasing their shares. The first major quoted company to take advantage of the share repurchase opportunities afforded by the 1981 Companies Act was The General Electric Company plc (GEC), in December 1984. Between December 1984 and March 1986 it repurchased some 3% of its issued share capital. This can no doubt be seen as an example of a company returning surplus resources to shareholders, although GEC preferred to put it slightly differently, stating that the purchases would be 'beneficial to shareholders generally, leading in the future to increased earnings per share of those remaining'.

Hard on the heels of GEC came J Rothschild Holdings PLC. Early in 1985, having sold off a number of sizable subsidiaries, J Rothschild embarked on a major programme of repurchasing its own shares in the market. Over the next three years it repurchased the equivalent of 33% of its issued share capital at the beginning of the period. The company's declared policy is to continue buying back its shares so long as it can do so at 'favourable' discounts to net asset value per share, its argument being that continuing shareholders benefit from a policy that boosts net asset value per share.

More recently still, Guinness PLC received permission from its shareholders in December 1987 to repurchase up to 10% of its share capital. The company said that it had been considering this step for some time, but the stock market crash had made it more of a priority.

But with a few major exceptions such as those mentioned above, interest among quoted companies in share repurchase seems in the last few years to have been largely confined to the property sector, where buying back shares at a discount to net asset value has commended itself as an apparently simple and painless way of increasing net asset value per share. Nonetheless, there are signs that, in the first bear market since the 1981 Companies Act, there has been an increase in interest in the opportunity to repurchase shares.

United States

In the United States the situation is very different, with regard both to the scale of repurchasing activity and to the reasons lying behind it. Every year, hundreds of firms repurchase shares. In the 1960s and 1970s by far the most important reason for share repurchases was to acquire stock for subsequent use in executive stock compensation or stock option plans. In more recent years stock repurchases have often been associated with efforts to get rid of troublesome shareholders (greenmail cases) or to reduce the risk of an unwelcome takeover. In the two weeks following the stock market crash some 650 companies announced plans to buy back shares in the open market, in addition to 350 companies which had announced programmes in the period from 1 January to 16 October 1987.

There have been several studies of the effects of share repurchase in the United States. Summaries of a few relevant articles are contained in Appendix 2. They tend to confirm in most cases that share repurchases have had the effect of boosting share prices above levels they would otherwise have reached. There is also evidence to suggest that share repurchases are more successful where the managers themselves have significant equity interests in the company.

The impact of the share repurchase programmes announced following the stock market crash has recently been the subject of study by the SEC.[1] Looking specifically at the effect of share repurchases during the week of 19–23 October 1987, SEC staff concluded that the purchases had a positive effect on the overall price performance of the relevant shares, and that announcements of repurchase programmes themselves appeared to have had a short-term positive effect on market price.

Other countries

Share repurchasing does not appear to have been carried out on a wide scale in Europe. In so far as repurchasing is a defence against takeovers this is no doubt because in several European countries there are more effective barriers available. In *Germany,* for example, banks have significant shareholdings in companies and are generally thought to be opposed to hostile takeovers; and in *the Netherlands* companies are so well armed with protective devices—in their articles of incorporation—that they are practically immune to takeover. In *Switzerland,* on the

(1) *The October 1987 Market Break,* published by the Securities and Exchange Commission in February 1988. See chapter 6.

other hand, the practice is more widespread. Perceived share undervaluation and takeover defence have been the prime motivations. In the recent past, however, Swiss companies have tended to resist takeover by refusing to enter the name of a new holder of registered shares in the company's share register.

Conclusions

The first part of this paper has demonstrated that there are arguments which cut both ways in respect of the desirability of share repurchasing by companies. The main benefits claimed are that it facilitates the distribution to shareholders of surplus cash resources; it provides a means of boosting a company's share price, both through increasing the underlying value of shares and through adding to demand for them (often through the announcement effect alone); and it provides another degree of freedom for a company wishing to adjust its capital structure.

The principal disadvantages of share repurchasing are related to the scope which it offers for abuse of creditors and non-selling shareholders. A recent phenomenon facilitated by the ability to repurchase shares is greenmail, which represents a specific case of abuse. Share price manipulation may also be facilitated by share repurchases.

The main restrictions on share repurchasing activity in the United Kingdom are the need to seek shareholders' authorisation at least every eighteen months (embodied in the Companies Act) and the 15% annual restriction on market purchases set by the Stock Exchange. These restrictions are in practice limited to twelve months and 10% respectively by the Investment Committee of the Association of British Insurers.

The more effective of these constraints is the 10% limit. This has recently been increased from 5%, and it is therefore too early to say whether it will meet companies' requirements. The new limit would appear to leave quite enough latitude, however, given that it is open to companies to reapply in successive years for further repurchasing authority. In any event, a balance has to be struck which does not open up the possibility of abuse—particularly, these days, greenmail. It may be, therefore, that 10% is as high a limit as is appropriate for a twelve-month period.

As regards the time limit for granting authority, it is obviously a nuisance, but probably no more than that. The eighteen-month limit for each authorisation by shareholders under the Companies Act is included in the relevant EC Directive and cannot therefore be changed unilaterally. The restriction to twelve months imposed by the insurance companies is probably not very material.

In sum, therefore, the City Capital Markets Committee is not pressing for any further changes in the regulations governing share repurchases. The Committee considers that the ability to repurchase shares is a useful weapon in a company's financial armoury, and that the possibility of using it within the currently existing constraints should be examined by company managements more often than hitherto. It is the Committee's view that the most effective way of making consideration of share repurchase more routine in the United Kingdom would be through changes in the attitudes of company managements and their shareholders. Some of the large investing institutions have already signalled such a change in attitude by increasing their limit on the proportion of share capital that may be repurchased in any year; so the next step may lie with company managements.

Appendix 1

Taxation of share repurchase in the United Kingdom

Tax consequences for repurchasing company

When a listed company repurchases its own shares, the transaction is normally treated for purposes of company taxation effectively as the payment of a dividend in so far as the cash paid out exceeds the capital actually subscribed for the shares repurchased (see Income and Corporation Taxes Act 1988, Section 209). The capital actually subscribed would include originally subscribed capital plus cash subscribed in any rights issues, but would exclude, for example, bonus issues or other internal re-capitalisations.

The company has to account for advance corporation tax (ACT) on the excess amount as if it were a net dividend payment. That ACT payment is, however, available for offset against mainstream corporation tax liability in the usual way. So, provided the company's mainstream corporation tax liability is sufficiently large, the only burden on the company is the interest cost of bridging the interval between the advance payment and the mainstream payment. This tax treatment must, however, be presumed to militate against share repurchase by companies suffering from 'unrelieved ACT' (ie with insufficent mainstream corporation tax liabilities to cover their existing level of ACT liabilities).

Tax consequences for selling shareholders

The tax consequences for selling shareholders depend on whether the company repurchases the shares directly or through the market.

Direct repurchase. In a direct, off-market, repurchase, the tax treatment of the shareholder is symmetrical with that of the company, with the capital and income elements of the repurchase consideration being the same as for the company. The capital element is dealt with under the capital gains tax (CGT) rules as if it were a realisation, and the income element is dealt with as if it were a net dividend receipt.

Market repurchase. With repurchases through the market this neat symmetrical treatment would not be practicable, because it would not usually be possible to match the company's purchases against specific sales by identifiable shareholders. Thus at the shareholder's end the transaction is normally treated entirely as a capital transaction, subject to the CGT rules, in the same way as any other disposal of shares on the market.

Tax cost comparisons

The relative tax efficiency of direct repurchases and market repurchases depends very much on the tax status of the company's shareholders, and also on the relationships among the repurchase price, the company's subscribed capital per share, and shareholders' acquisition prices for CGT purposes. Similar considerations apply to comparisons of the relative tax efficiency of share repurchases and dividend payments, considered as alternative ways of transferring cash from a company to its shareholders.

The following table illustrates how the comparisons can vary according to the tax status of the shareholder. The basic story lying behind the table is that a company (with no problem of unrelieved ACT) has a given amount of surplus cash that it wishes to distribute to its shareholders either via a share repurchase (direct or through the market) or via a net dividend payment. The company's subscribed capital per share is calculated to be a proportion, k, of the repurchase price. Three categories of shareholder are considered: gross funds, standard rate taxpayers (paying 25% on income and 25% on capital gains) and top rate taxpayers (paying 40% on income and 40% on capital gains). Gross funds are able to reclaim ACT paid by the company at a rate of 25% of the grossed-up dividend, which is equivalent to one third (25÷75) of the net dividend. The taxpaying shareholders are assumed to have a common acquisition price[1] for CGT purposes, representing a proportion, p, of the repurchase price, and to be able to offset any CGT losses against CGT gains on other transactions. The table shows, for each method of distribution and each category of shareholder, the net impact of a distribution of £R on the aggregate tax bill of the company and its shareholders. (No account is taken of ACT or other timing differences.)

Tax status of shareholders	Tax cost (£) of distributing £R via:		
	Direct repurchases	Market repurchases	Net dividend
Gross funds	$-0.33(1-k)R$	0	$-0.33R$
Standard rate (25%)	$0.25(k-p)R$	$0.25(1-p)R$	0
Top rate (40%)	$(0.2+0.2k-0.4p)R$	$0.4(1-p)R$	$0.2R$

k = Subscribed capital per share as proportion of repurchase price ($0<k\leq1$).

p = Shareholders' acquisition price for CGT purposes as proportion of repurchase price ($p>0$).

A number of conclusions can be drawn from the analysis of this simple model:

(i) *Direct repurchase v market repurchase*
Direct repurchase is generally more tax efficient than repurchase through the market for all categories of shareholder. (The only exception to this statement occurs when $k = 1$, ie when the *whole* of the repurchase consideration is treated as a return of capital. In this case direct repurchase and market repurchase are *equally* tax efficient for each category of shareholder.)

(ii) *Direct repurchase v dividend distribution*
- (a) Gross funds: Dividend distribution generally more tax efficient.
- (b) Standard rate: Direct repurchase more tax efficient provided $p>k$.
- (c) Top rate: Direct repurchase more tax efficient provided $p>\frac{1}{2}k$.

(1) The acquisition price for this purpose is actual acquisition price or 31 March 1982 value, whichever is the greater, subject in either case to indexation.

Appendix 2

Summaries of selected academic studies of share repurchase in the United States

Dann, Larry Y, 'Is your Common Stock Really Worth Buying Back?', *Directors and Boards*, September 1983, pages 23–9.

Dann examines the conceptual merit of the rationales for stock repurchase cited most frequently by corporate managers and the financial press. One common rationale is that the market's expectation of future earnings-per-share (EPS) is increased. On this topic, Dann concludes that an EPS increase will occur only if the company's financial leverage is raised, which also raises the common stockholders' risk. Another common buyback rationale holds that stock repurchases allow a company to move toward its optimal capital structure. Dann points out, however, that companies can achieve this same result by relying on debt as the primary source of new external financing. Other questionable buyback advantages include: (1) reducing stockholders' personal taxes; (2) reducing total dividend payments; and (3) investing in undervalued stock. While Dann concedes that the buyback of undervalued stock represents a good investment for the company's remaining shareholders, he is sceptical of managers' abilities in identifying undervalued situations in an efficient market.

Fraser, Donald R, John C Groth and Malcolm R Richards, 'Share Repurchase: Your Best Investment?', *Financial Executive*, November 1980, pages 20–23.

In this paper, the authors conclude that 'in most instances, the decision to repurchase is quite consistent with the prescriptions of financial theory . . .'. They claim that when firms cannot invest funds in investments with favourable risk/reward characteristics in relation to alternative uses of investor funds, these funds should be returned to shareholders. This may be done by repurchasing shares, creating a capital gain which is taxed at a lower rate than if shareholders received dividends. Care must be taken, however, in a share repurchase programme so that the IRS allows the repurchase as a bona fide exchange. Repurchases are allowed as exchanges if: (1) the redemption is not really the equivalent of a dividend; (2) there is a disproportionate stock redemption; (3) the redemption terminates the shareholder's interest; or (4) if the redemption involves stock issued by railroad corporations in certain re-organisations.

Loomis, Carol J, 'Beating the Market by Buying Back Stock', *Fortune*, 29 April 1985, pages 42–8.

This article identified and studied companies that voluntarily bought significant amounts of their own common stock in the ten years from 1974 to 1983. Total returns (stock appreciation plus dividends) earned by remaining shareholders of buyback companies were measured and compared to returns of the S&P 500 Index. The median total return of the remaining shareholders outperformed the S&P Index by 850 basis points. The main point of this article is that stock repurchases worked very well for these companies only because the stock was truly undervalued at the outset. Investors are cautioned as to future buybacks because companies may be repurchasing stock simply because it is in fashion to do so—or because they fear takeover.

Richards, Malcolm R, Donald R Fraser and John C Groth, 'Why Firms Repurchase Common Stock', *Business*, Oct./Nov./Dec. 1982, pages 33–8.

Financial officers of 62 firms involved in stock repurchase programmes were surveyed to determine the motivations underlying the programmes and the factors leading to their success. Stock repurchase programmes were most commonly undertaken: (1) when the stock was perceived to be undervalued; (2) when excess cash was available; (3) when stock was needed for stock option and retirement plans; and (4) to improve earnings per share. Programmes were most successful when the stock repurchase was well-timed, given market conditions, and when the programme did not involve costly financing that hindered corporate operations. As the authors conclude, '. . . nothing uncovered by the survey suggested that these programmes had adversely affected the firms involved—and some visible signs suggest they may have helped them'.

Vermaelen, Theo, 'Common Stock Repurchases and Market Signalling: An Empirical Study', *Journal of Financial Economics*, June 1981, pages 139–83.

This paper examines the pricing behaviour of securities of firms which repurchase their own shares. The author studied 131 tender offers made by 111 firms and 243 open-market purchases made by 198 firms. He concludes that firms which repurchase their own shares experience a permanent increase in stock price, on the average. He claims that the results are consistent with the hypothesis that firms offer premiums mainly in order to signal positive information, and that the market uses the premium, the target fraction of shares to be purchased and the fraction of insider holdings as signals in order to price securities around the announcement date.

The observation that repurchases via tender offer are followed by abnormal increases in EPS and that it is mainly small firms that engage in repurchase tender offers, provides further support for the signalling hypothesis. In addition, the author suggests that it is possible to reject the hypothesis that tax effects are the predominant explanation for the abnormal returns following the average tender offer and that it is probably safe to conclude that expropriation effects (in which shareholders gain from the loss in the value of bonds caused by increased leverage) also cannot explain these abnormal returns.

Wansley, James W and Elayan Fayez, 'Stock Repurchases and Security Holder Returns: A Case Study of Teledyne', *Journal of Financial Research*, Summer 1986, pages 179–91.

This study analyses the impact of corporate repurchase announcements by examining the common stock, straight debt and convertible preferred stock returns around nine major and ten additional associated corporate repurchase announcements made by Teledyne between 1972 and 1984. Consistent with prior findings, statistically significant positive excess returns to common stock and convertible preferred stockholders are documented. Contrary to prior research, however, the study has two major findings. First, neither the absolute level nor the significance level of the announcement effects diminish with subsequent announcements. Second, there is a wealth transfer from bondholders to stockholders. Bondholder returns around the repurchase announcements are significantly negative. The authors conclude that this '. . . departure from prior findings illustrates the usefulness of examining individual corporate events in detail'.