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Could 80% of All UK and EU Buybacks Executions Be Considered Market Abuse?

We question this thesis using the Diageo's Oct '23 – May '24 Buyback as a case study

Introduction

Imagine paying an 8% fee just to receive your dividends - the uproar would be deafening. Yet, when it comes to share buybacks, companies are sometimes paying eye-watering transaction costs, at times 8% or more.

As buybacks surge across the UK and EU, with an estimated €500 billion set to be repurchased this year, a harsh reality has come to light: the very execution methods used for up to 79% of these buyback programmes could be in breach of the Market Abuse Regulations.

While dividends come with virtually zero transaction fees, the same cannot be said for buybacks. As we delve into the case study of Diageo's recent buyback execution it becomes clear that the excessive costs could stem, at least in part, from legal infractions.

A prominent City lawyer's ominous warning echoes in our minds: "...if there is one thing that history tells us a company does not want, it is an illegal share buyback or dividend..." And as much as we hope this argument proves unfounded, the evidence suggests otherwise.

We have proposed improvements to the execution environment for share buybacks, outlined in a letter sent to the FCA and later copied to ESMA. When it comes to shareholder returns, every basis point counts – and the hidden costs of buybacks executions can no longer be ignored.

Overall Objective of this Case Study

Our objective with this case study is to expose the potential market abuse and poor practices plaguing buyback executions across the UK and EU. We aim to shed light on the how a family of widely used execution products could be facilitating these infractions. We call these the "problem products".

This is not an exercise in critiquing how better outcomes could have been achieved, nor in suggesting alternative designs. Before we can improve these practices, we must first identify the root causes and shine a spotlight on the faults inherent in the current execution landscape.

Diageo, you're not alone in this predicament. We have singled you out not as a target but as a case study, having scrutinised the executions of your recent buyback programs more closely than most others.

Diageo's Oct '23 to May' 24 Details

On the 12th Oct '23 Diageo announced a new $1bn share buyback programme. In their disclosure statement it is worth pointing out a few critical components which we will refer back to.

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1) The **purpose** of the buyback is to **reduce the share capital** of Diageo
2) Diageo entered into a **non-discretionary** agreement with their broker
3) The **broker makes all trading decisions** within certain pre-set parameters prescribed by Market Abuse Regulations (MAR)
4) Any fees are payable **by or to** the broker under the terms of their agreement

Before we delve any further into this buyback programme of Diageo's, we need to cover a few basics.

The Mechanics of an Open Market Share Buyback

When a company executes an open market share buyback, they spend a portion of their own capital to buy shares on the public exchanges. The selling shareholders receive this capital as the proceeds of their sales. The benefit for the remaining shareholders is that each of their shares will own an increased proportion of the company. There are obviously conflicts here. The sellers benefit the most if they sell their shares at higher prices, realising the greatest value per share. The holding shareholders benefit the most if the company buys as many shares as possible at lower prices. The corporate management might be evaluated on EPS, or relatives share price performance etc. Our UK and EU MAR rules are designed, in part, to prevent any share price manipulation that might benefit any parties.

The Board Legal and Fiduciary Responsibility during the execution phase of a buyback

The board has a duty to balance the interests of all parties. We need to briefly address the responsibilities to different shareholder groups separately, whilst also bearing in mind that the board has many other factors to consider, such as their duty to ensure that the buyback is carried out lawfully etc.

Our laws require that companies disclose several levels of information relating to buybacks: The board approval, specific programme details prior to execution, and reports on any daily trading activity as the execution progresses. The company also have some specific duties such as ensuring that a reasonable portion of the value of the buyback is used to buy shares, meaning cost control over execution fees etc.

Duty Specific to the Selling Shareholders

The boards duty to selling shareholders is interesting. This is because, in the cases we are discussing, all the shares are bought on public exchanges. Unlike a tender offer process, open market buybacks typically do not purchase shares directly from shareholders, rather via a public exchange such as Aquis, Deutsche Börse or the LSE. The issuer's shares trade freely on public exchanges all the time, so shareholders do not require a share buyback to make sales. All shareholders are free to sell their shares whenever they choose, use whatever price limits, timing and execution strategies that they so desire. The board does not have control over if and how shareholder sells. Therefore, the board has limited meaningful responsibilities which are specific to the execution phase of a share buyback beyond the disclosures and cost controls already mentioned.

Duty Specific to the Holding Shareholders

Conversely the shareholders who remain have no control over if, how, when, at what prices, which broker, what fee structure... that a company may employ to implement any buyback. These shareholders depend entirely on the board's fiduciary responsibility to look after their interests. As we have already mentioned, from the very specific perspective of the execution phase of a buyback, the

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interest of the holding shareholders relates to how many shares are repurchased. The number of shares that the programme manages to purchase is determined by a combination of variables such as the nature of the execution strategy, the share price path and how much volume the share trade along that price path. Just to be clear here, a holding shareholder, like all shareholders has an interest in a higher share price in the longer term. However, all else being equal, if they hold their shares long term, they benefit the most if the buyback is implemented at lower share prices. This is a short-term price path comment, not one about the long-term share price.

The Law

In their disclosure statement Diageo referenced some specific regulations[1] under which the buyback would be executed. We are not lawyers, but our summary is that the starting point of these regulations is that they say it is market abuse for a company to buy its own shares. Issuers can claim an exemption from this market abuse if the sole purpose for the buyback is one of three given choices. The first, and most popular exemption is if the sole purpose is "to reduce the capital of an issuer".

In Diageo's disclosures they appear to claim this exemption when they say that "The purpose ... is to reduce the share capital of Diageo plc.". There are certain conditions that also need to be followed to claim any of the exemptions. These conditions include disclosure requirements and restrictions regarding the "conditions of trading". Conditions of trading are such things as the timing, price and speed of the buying of shares. It appears that Diageo have followed all these other constraints without issue.

The Potential Market Abuse Breach

The potential market abuse breach relates to the interpretation of the exemption. The exemption requires that the "sole purpose" be to reduce the share capital of an issuer.

What does "sole purpose" mean in this context?

It is frequently suggested that this refers to the overarching reason for the company to do the buyback. The idea that the language "sole purpose" is referring to the need for a genuine commercial reason for the buyback i.e. the primary purpose should not be for reasons that are purely tax related for example. There might be a dominant reason, however, buybacks act as a conduit to return capital to shareholders, they consolidate ownership, transfer value between shareholders, change the capital structure of the firm etc. and they do all these very different things simultaneously regardless of any intended reason.

The context of the term "sole purpose" is important. The legal language we are discussing is a very specify requirement needed to claim an exemption to market abuse i.e. Article 5.2(a). Market abuse relates to topics such as share price manipulation, unlawful disclosures, insider trading and so on. Market Abuse does not directly relate to corporate leverage, capital return mechanisms, ownership consolidation etc. If a buyback programme purchases and cancel 1 share or 1 million shares both quantities reduce the share capital of the firm. "Sole purpose" in this context means that reducing equity capital must be the singular intent.

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[1] Market Abuse Regulation 596/2014, the Commission Delegated Regulation (EU) 2016/1052 (both as incorporated into UK domestic law by the European Union (Withdrawal) Act 2018) and, in the case of Diageo, Chapter 12 of the Listing Rules.

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When you read the Article 5 legal exemption, through the lens of the board and companies' fiduciary requirement we think this becomes clearer. The intent of the execution of the buyback should be attempting to maximise the number of shares repurchased for the finite value allocated to the buyback programme. When we look at this Diageo case study we are looking to see if we can ascertain the intent of the buyback.

Trading Impact and Price Manipulation

Part of the reason why the law starts with "share buybacks are market abuse", is because when shares are purchased, all else equal, buying impacts share price. There is no way around this. However, the way purchases are carried out can limit the scale of any price impact. If there were no regulations constraining this process, then the risk of share price manipulation would be high.

There is a whole industry within finance that is focused on the reality that the execution of orders impact share prices. A series of business models are predicated on this, think market makers, different exchange models like dark pools etc. On the other hand, investors, brokers, everyone obsess over trying to minimise not just the impact of their trading, but their overall transaction costs. Both practices drive healthy and efficient markets.

There are two basic components to transaction costs. Explicit costs like taxes and commission, and implicit costs such as price impact and price slippage. There are three relevant findings from academic research that drive implicit costs. Implicit costs increase with the size of an order, the time taken to execute an order, and the speed at which it is executed. These are all related to each other.

How do the above-mentioned regulations play into maintaining orderly markets with respect to the implicit costs of executing share buyback programmes? The programmes we are addressing in this article are typically large in terms of value. The regulations do not really limit the size of share buyback programme. There are, however, clear regulations that govern how fast and under what share price conditions a programme can be executed in the open market. The specific language that relates to the speed are the conditions of trading. These limit the maximum volume that a company can buy shares on any given day. This is expressed as a function of the rolling historical volume of shares trading on the exchange on which they are being bought (For UK, FCA Technical Standards Article 3). The speed at which the share buyback progresses, or at least the maximum speed, which is allowed, influences the overall duration it takes to complete the buyback.

Optimising for What?

As of the 29th of May, '24, Diageo appear to have completed the share buyback programme mentioned above. In their daily "transaction in own shares" reports, they have disclosed that they have purchased a total of approximately 27.5 million shares. Are there any clear signals that indicate that the "sole purpose" was not the singular intent to reduce their equity capital? To do this we need to ask the question: What is the execution strategy optimising for? Anything other than reducing their equity capital is a problem.

Benchmarks and Broker Incentive

To explain the relevance of an execution benchmark and a broker's incentive we will consider a few hypothetical examples. In this exercise we assume the same Diageo's disclosure statement would be disclosed prior to executing each hypothetical example. We also assume that in each case the entire

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programme was executed within the "conditions for trading" guidelines and all the requisite disclosures and other reports were carried out correctly. Please allow for a little bit of licence around the completion dates etc.

Hypothetical example 1

Imagine if ..... Diageo gave their broker the official LSE closing price of their shares on Friday the 28th June as the execution benchmark for their buyback. This is the last trading day of their fiscal year. The contract they agreed required that the broker guaranteed that the programme would be complete and the average share price for the overall programme would be no worse (no higher) than the benchmark price. The fee structure in the contract said that Diageo will pay the broker a sum equal to 50% any out-performance, and the broker would pay Diageo a sum equal to correcting for any under-performance.

The Diageo share price closed at £30 on the 28th of June.

If the average price of the purchased shares they bought in the market was £31, then the broker owes a "fee" to Diageo of £1 a share.
If on the other hand the average price of the purchased shares in the market was £28, then Diageo owes the broker £1 a share.

Would this arrangement be considered market abuse?

Our gut instinct screams market abuse. It smacks of "window dressing", i.e. Diageo trying to influence their share price on the last day of their financial year etc.

A more formal answer.

In their announcement disclosure Diageo state, the purpose of their buyback programme is to reduce their share capital. Is the execution strategy optimised to reduce their share capital? No.

In equity execution sometimes a clients give the broker an objective of beating a benchmark. In our example 1 the execution benchmark that the broker is incentivised to out-perform is a future share price. Nobody knows what that future closing price will be when the broker and issuer agree execution contracts. However, if the broker is incentivised through a fee structure that rewards achieving a relatively lower purchase price, and penalised for a higher one, then the execution strategy will be optimised to try to achieve a favourable outcome for the broker. This arrangement is not designed with the "sole purpose" to reduce the share capital of the firm. What is being optimised is the relative difference between the eventual closing price and the purchase price, be that a closing price of £10 or £100. The relative purchase prices of £9 and £99, have the same outcome for the broker and the same fee paid by the company. An average purchase price of £9 and £99 will result in a very different number of shares purchased. Clearly in this hypothetical case the incentive structure does not align the brokers interests with those of the holding shareholders. By setting a future share price as the benchmark, there is no consideration towards optimising for how many shares that this would result in being repurchased and cancelled.

Nobody ever knows how many shares any buy order will purchase if the share price is always varying. There are, however, strategies which are optimised to try to maximise for the number of shares purchased. Using a future share price as the benchmark is not one.

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The point we are trying to make is that to claim the exemption from market abuse, the execution arrangement should be optimising for reducing the number of shares in issue. If there is an accompanying incentive fee structure, then it should align the shareholders' interests with the brokers.

Hypothetical Example 2

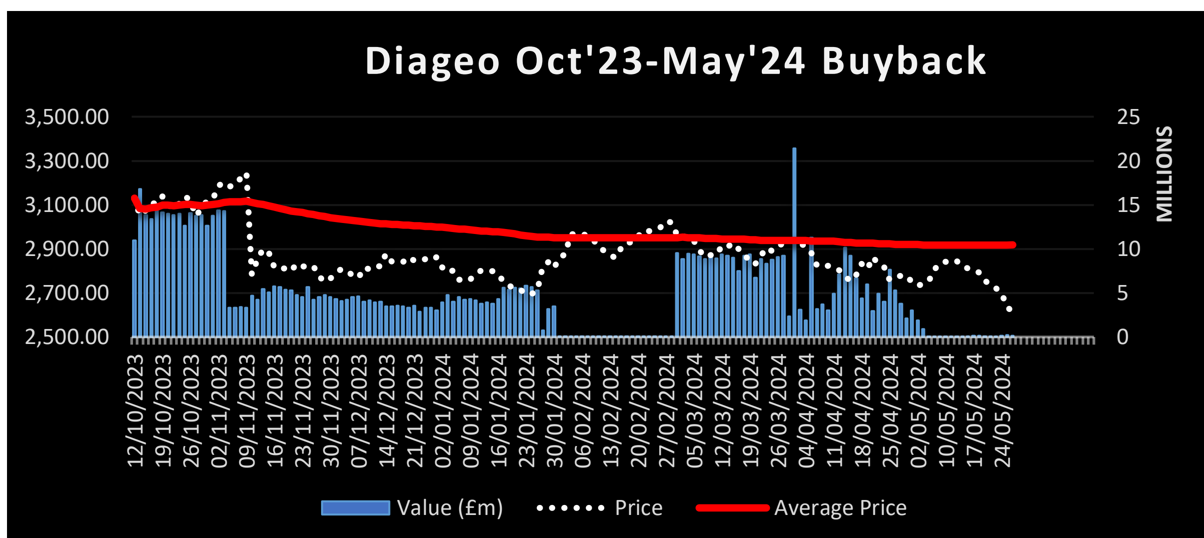
If the benchmark is modified, but the rest of the process and structure remains the same, does this change the conclusion? It depends. For example, what if the benchmark became the simple average of the closing prices of the 5 trading days before the year end, or the 100 days prior, or a variable number of trading days? It is hard to make a case for a different conclusion in these examples to the single closing day price example. This is because the programmes execution process is still not optimised for the quantity of shares, but for the average purchase price relative to a future unknown share price.

Diageo's Recent Buyback

Diageo's disclosures told us that they had entered into a non-discretionary agreement with their broker, and that the broker was making all the trading decisions. They also gave hints to suggest that the broker had some sort of performance incentive by telling us that the "fee" could be payable **to or by** the broker. Some of the language used, especially the part about the multi directional fee, suggestions that there may also be a benchmark and incentive alignment problem.

Let's look at the trading footprint of the buyback, compiled from their "transaction in own shares" regulatory disclosures. The chart shows the approximate daily traded value so we can first look at the way that the $1bn was spent.

Chart 1



There are lots of question we can ask, but just because we might not understand, this does not necessarily mean that there is a problem. We list a few questions as the programme progresses to ask if there are any problems?

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1) The first obvious question is why, in week three, does the broker slow down the daily spending? They were spending around £14m a day (RHS blue bars). The share price falls from around £31 down to around £27 on a Diageo preannouncement, and the broker slows down to only spend around £4m and £5m a day. They keep this pace for a full 55 days after the pre-announcement while the share price was about 10% lower that at the start. Why?

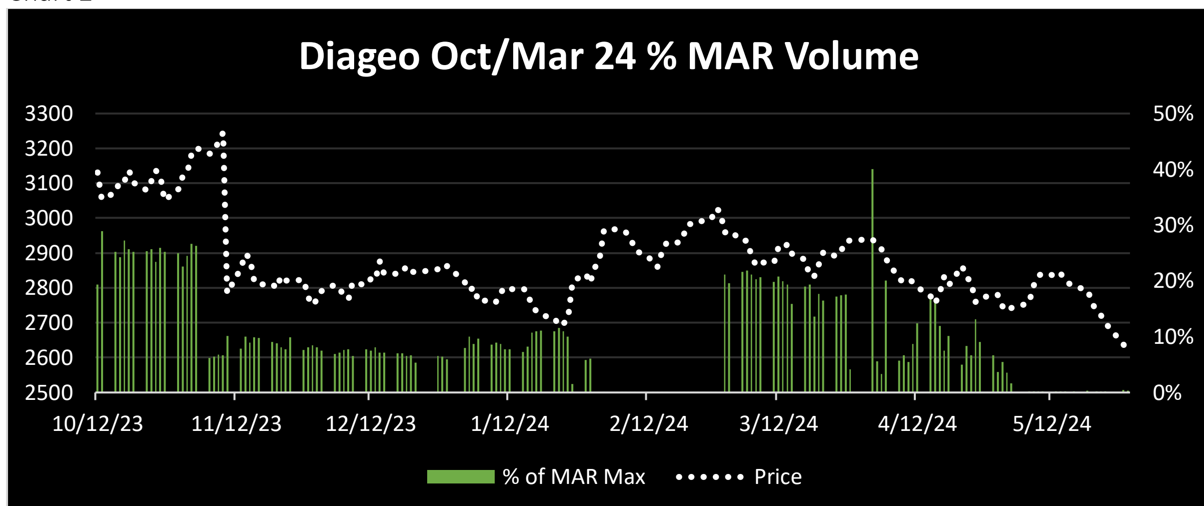
2) Then on the 31st of Jan, the broker essentially stops. Between the 31st of Jan and the 28th of Feb, the share price slows raises about 7%, by the 28th of Feb it is back to £30, still below the share prices at the start of the programme. In this entire time the broker spends a total of around £0.5m, spending roughly £25,000 each trading day. Why?

3) Then on the 29th of Feb, Diageo's shares go ex-dividend (32p a share), and the brokers starts spending 36 thousand times more money each day, around £9m, but the share price is no lower than it was than it was at the start of Feb. Why?

Common sense might tell you that absent any other good reason, if your goal is to buy as many shares as possible, spending more money at lower share prices is better than at higher prices. But there may be very good reasons not to do this. At the start of a programme nobody knows what the future share price path will be, nor how the broker may evolve their strategy as the process evolves. If the share price goes down, logic might tell you that you should be spending at least the same amount as you were before, if not more. But there may be valid reasons not to do this, we just do not know.

The first thing we do is rule out any regulatory reasons that might control the pace that the broker is spending. There is a regulatory volume control that limits the daily spending as one of the "conditions of trading". If the overall market volume of Diageo's shares was low relative to how many shares the broker was trying to buy, this may have been preventing the broker from speeding up at lower share prices.

Chart 2



In Chart 2 we look at how much value did the broker trade each day as a % of the maximum that we believe would be permitted under MAR[2].

[2] To estimate the MAR maximum allowed daily volume we use BMLL's historical volume data (Thank you BMLL). We took the daily executed value of the Lit order books of the LSE, Aquis, and the two CBOE exchanges. We calculated the historical 20-day average value traded on each exchange, and then summed 25% of each.

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The green bars in this chart is the value that the broker executed each day as a % of our estimate of the maximum allowed under MAR for that day (RHS). The height of the green bars is between 5 and 15% for the entire 55 days post Diageo's share price fall on Nov 10th. We estimate that the broker never got close to using the maximum allowable on any day. This means that the market volume was not a likely limiting factor. To execute this programme Diageo and/or their broker choose to only trade on the LSE, however this is a choice. For example, the broker who executed Diageo's programme that started in Feb '22, used the [LSE and both CBOE exchanges](). If we do the same maths and just use LSE volumes, the daily volume was still well below 100% for this entire period.

We believe that the unique incriminating evidence is revealed in question 3. How the broker modifies their trading behaviour prior to and immediately after known share price changing event is key. Before the start of the programme Diageo had disclosed a 32p dividend, the share price was due to go ex-dividend on the 29th of Feb. This trading pattern is a [unique characteristic]() of this set of "problem products" that we mentioned on the opening page.

Mitigating circumstances?

It is entirely possible that Diageo will have been compensated by their broker. The broker may well have been contracted to guarantee an outcome. Without more information we have no way of estimating if a payment has occurred, or the magnitude if any payment was made.

There are however multiple phrases in their disclosure statements which suggest this possibility. The key phrase to us is the one that says "...to enable the company to buy-back shares with an aggregate value of up to $1.0 billion (net of any fees payable to or by *their broker*...)". By our maths, the company repurchased approx. £801m. We do not yet know what FX rate was used to calculate this value in dollars. If we use the simple average of the daily FX price, we get a $ number comfortably within a percent of $1bn.

Did the brokers execution under-perform (miss) a benchmark?

The common benchmark used in these "problem products" is the simple average of the daily share price over the number of days that they took to complete the programme, one we call the "bogus benchmark". When we look at the weighted average purchase price for the programme and compare this to the bogus benchmark it looks like the broker underperformed this average by over a percent. We also do not know if the broker was guaranteed to share price lower than this benchmark, say 50 or 100bp below. So if there was a payment, we cannot tell the magnitude.

However, we cannot rule out that Diageo may have received a payment from their broker, or a "fee" as mentioned in the disclosure. If this is true, then where is the harm? Maybe the buyback programme under purchased shares, but then the company received compensations for this. The payment was received after the buyback was complete, so only the holding shareholders benefit from this. Everything is fine, right?

No, everything is not fine. The compensation was based off a ["bogus benchmark"](), but that is for another time. The more important point for this paper is the legal perspective. How should we think about any possible "fee" paid by a broker to a corporate? Whose purpose is to compensate for the broker buying shares on behalf of the company at a contractually higher price than the broker guarantee?

Are these "Fees" Price Adjustment Mechanisms?

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The structure of these buybacks is that each day the broker chooses how much money to spend to buy shares in the market. At the end of the day the broker books out the purchased shares to the corporate who pays and settles those trades. The company publishes the number and the price of the purchased shares each day via their "transaction in own shares" regulatory disclosure notice. The Companies Act 2006, chapter 4 states that when a "company purchases its own shares the shares must be paid for on purchase". The company has already paid for the shares purchased each day. The relative out or under performance of those purchases is only know when the programme is complete, and the benchmark is finalised.

To use one of our earlier hypothetical examples. If the benchmark price the broker guaranteed was £30, and the broker purchased the shares at an average price in the market was £31 per share. In this case the broker would owe a £1 per share penalty fee, that needs to be paid to the company.

The purpose and the effect of this penalty "fee" is to lower the purchase price of the shares that the company has already bought, from £31 to £30 a share. It is hard to interpret this "fee" as anything other than a share price adjustment. We believe these sorts of price adjustments are not permitted in any equity transactions. However, in the case of buyback this is spelled out very clearly in the Companies Act 2006 law already mentioned.

We understand that some legal teams advise a cap on any such fee to lower the risk that these fees are interpreted as share price adjustments mechanisms, rather than a fee. We can understand the desire for fee caps, but a cap does not change the purpose and effect of any retrospective payments from the broker to the corporate, regardless of what you call it.

Performance Fee Penalty Paid in Shares

In Europe last year it appears that a broker did owe a similar performance fee. The fee was paid through the broker buying and paying for additional shares at the end of the programme. In the case of Diageo, the phrase "net of any fees" in their disclosure statement suggests room for this possibility. One could argue that a performance "fee" payment made in this way does comply with the daily trading report requirements, the companies act and the boards fiduciary requirement to their holding shareholders.

We cannot tell if this was the case for Diageo without knowing the FX rate to calculate what the $ spend was. If the $ spend was greater than $1bn, then this solution could have been used. However, with the information that we have to date, this looks unlikely given the apparent magnitude of the underperformance.

An example of a broker paying a fee through purchasing additional shares is shown in ING's 17th Oct '23 press release after they completed a buyback programme. They explain that their buyback ended up being 104.4% of the target value because of a performance arrangement with their broker, however they go to say that the effect of this arrangement was to reduce the purchase price of the original 100% by a little over 2%. Which brings us back to the question that if the purpose of the fee arrangement is to adjust the purchase price?

Transaction in own share reports

The other reason for this long discussion about performance fee payments is currency payment is made, is there now another breach of the market abuse rules? The reported transactions on the trade date no do not reflect the actual price that they company paid, once a fee payment has been

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received. Accurate reporting disclosures are one of the requirements in order to claim exemption from market abuse.

“Problem Products” and The Sale of Appropriate Financial Products

The are family of problem product we are talking about are generally structured and priced by the exotic options teams within investment banks derivative businesses. These products go by nicknames such as “VWAP-minus”, “VWAP-discount”, “Optimised- VWAP”. VWAP stands for Volume Weighted Average Price. VWAP is a well know execution benchmark which has many different varieties. The version of this benchmark wrapped up in these share buyback solutions is not the same as those used by the rest of the trading community. These products have several imbedded design features that seem to make them unsuitable for the buyback exemptions in the UK and EU market abuse laws. In addition, they do not seem to uphold the corporate board’s fiduciary responsibilities in when executing a buyback either.

There is no hard data that we can find to quantify these products market share of UK and EU buybacks, however their use appears to be widespread. This is problem is not just observed in the UK, and not just by Candor Partners. Here is a link to an article written by a market structure expert at Deutsch Börse. The article asks similar execution optimisation questions about the buyback footprints of BMW, Siemens, SAP and Deutsche Börse itself. A broker survey from 2019 reported that 79% (graph 3) of issuers prefer to use this forward looking average price benchmarks.

Brokers in the UK and EU have a regulatory responsibility to know their clients and to only sell them suitable financial products for their needs. They are therefore required to understand what the corporate client needs are for a product that is sold as being designed to operate within both the regulatory framework. Failure to sell a suitable product is a breach of the brokers regulatory responsibilities.

What are the consequences, are they material?

Leaving aside any potential legal issues. There are many of components that need to be discussed to answer this correctly. This case study is not the right forum to discuss them all. Diageo’s share price path presented a very real opportunity to buy many more shares.

Estimating exactly how many shares they could/should have been purchased is an exercise in the counter factual. The order of magnitude is likely to be measured in percentage points not basis points. However, the simple answer is yes this really does matter. The consequences are both material and their effects will compound with time. This is because the ownership of each share in the company going forward is more diluted that it otherwise would have been. To compound this again, it is not a first-time problem for Diageo. We all know that the power of compounding is not one to underestimate.

Why Does this Matter?

Institutional investors obsess about the frictional cost of trading. They understand that any inefficiencies in the execution of their orders is a direct cost on their performance. When issuers are buying back their own shares, they are essentially doing this on behalf of their shareholders. The execution of share buybacks needs to be optimised for the right outcomes and the resulting performance and costs should be measured correctly. All share buyback frictional costs are ultimately borne by the issuer’s investors.

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Make Our Markets Better

We are in an environment where we are asking questions about why our capital markets are losing listings, issuers are trading at valuation discounts, and investors returns are relatively poor. If we can make simple changes to the efficiency of the transmission of capital from issuers back to investors, then should we be exploring this?

In the UK and EU over the last two years, companies have repurchased in the region of £500bn worth of their own shares. In Diageo's case it is very clear that this trading pattern has resulted in many shares being left on the table. In other cases, we have analysed the fees extracted by brokers have been north of 8%. We do not know the precise excess cost of this inefficiency, but every 1% would be £5bn across the UK and EU each year. Do the maths, when you compound this sort of excess cost each year it gets very large very quickly. Compare these figures with the value of capital raised via IPOs in the UK in this period? Less than £2.5bn. It matters!

Dividends and buybacks are the only to viable mechanisms for issuers only to return capital to their investors. As a whole market, we really need to also obsess over measuring and managing the fictional costs of transferring this hard-won capital. All investors and brokers know how to do this, it is our day job. When buyback are executed efficiently, investors can then reinvest their improved returns into other issuers and help stimulate our IPO market.

Candor Partners Limited, offers a consultancy service to help corporates execute share buybacks (and other share transaction) in an efficient and regulatory compliant manner. This service is designed to also help boards discharge their governance responsibilities throughout the implementation phase of these large capital allocations. We help marry objective with outcomes, help estimate costs, and then measure and evaluate the results.

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