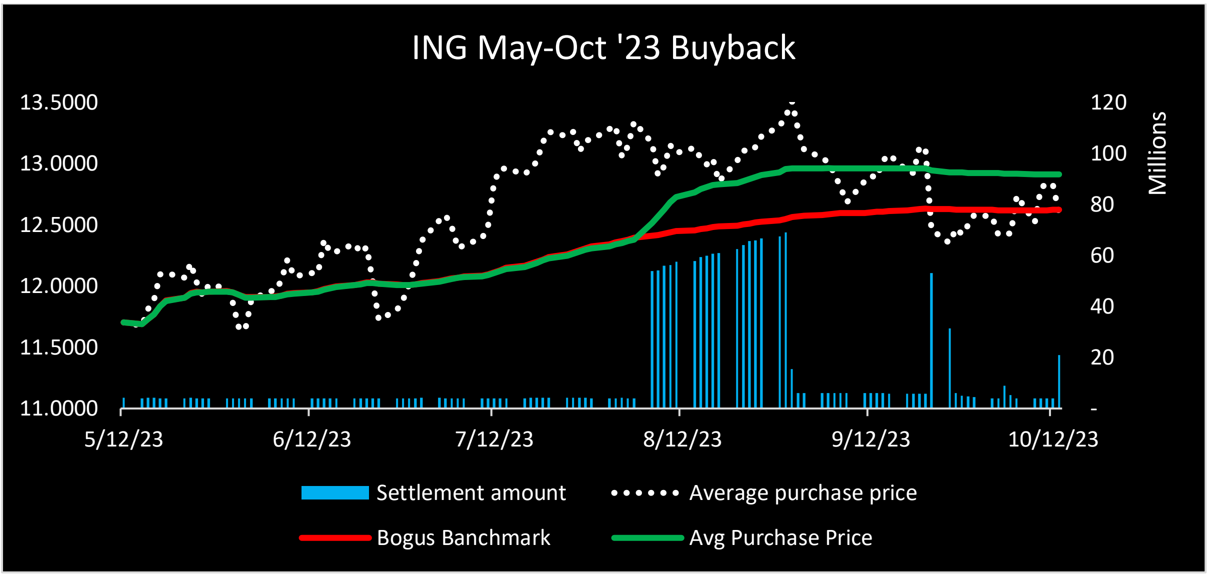
Candor

The Cum-Ex Issue – A new buyback flavour

We question an execution practice using ING Bank's May – Oct '23 Buyback as a case study



Introduction

We have been asked to give examples of some of the specific issues we see within the execution of share buybacks. As part of this process, we are writing a series of case studies. The purpose of this case study is to focus on issues that relate to share prices going ex-dividend while a share buyback programme is being executed. We have covered this dividend topic in part in some other articles. This article is focusing on the potential breaches to the exemption for market abuse exemptions for buybacks, specific to trading activity around dividend ex-dates.

The execution of this ING buyback was bizarre, and lots of questions have been asked by various market participant. The questions we fielded were mostly focused on a curiosity as to who was the broker, did they lose €66m? Questions on the unusual trading footprint, and questions challenging the legality of execution process. We are not lawyers, so please treat these as questions, not answers.

ING's May to Oct '23 Buyback

On the 11th May ING announced a €1.5bn share buyback, expecting it to be completed no later than the 18th of Oct. On the 17th Oct ING announced the completion of this buyback programme. There are several items that we think are worth pointing out.

1) ING had already announced a €0.35 dividend with an ex-date on the 7th Aug '23

2) ING outsourced the trading decisions of the buyback programme to a broker
3) A total of €1.566bn worth of shares were purchased. 4.41% or €66m extra
4) The extra €66m was paid by the broker due to "performance arrangements"

The Trading Footprint

The main questions we were asked related to the unusual trading footprint you can see in the chart above. The reports showed ING purchased €4m (blue bars RHS) each day for about 3 months while the share price rallied 6% (white dotted line LHS). Then, at a higher share price spent about €1bn in just 17 trading days.

What Happened and Why?

We don't know; however, this is what we have been able to piece together. ING's IR confirmed that they had contracted a broker who guaranteed that ING would buy shares at a discounted purchase price to the simple average of the daily share price over the programme, what we call the "bogus benchmark". This benchmark does not adjust for the share price going ex-dividend.

These so called "VWAP[1]-discount" or "VWAP-minus" contracts[2] are privately negotiated, and usually have parameters that stipulate the minimum and maximum timeframe within which the broker must complete the programme. In this case the broker took about 100 trading days to purchase the contracted €1.5bn (prior to making good on the "fee").

The trading schedule required to match the performance of "bogus benchmark" over 100 trading days is to trade 1% of the total value each day, at the daily benchmark price. So, the risk neutral value to trade every day for this programme was approximately €15m each day.

As you can see from the chart on page 1, the company reported that it purchased about €4.1m each day, for the entire time that the shares were trading cum-dividend. This means that by the 4th of Aug, the company had purchased a total of about €250m shares. The "risk neutral" position for the broker would have been if they had purchased about €915m. It appears that the broker had under purchased by €665m.

On the 7th of Aug the share price went ex-div. The company reports buying €54m worth of shares on the 7th Aug, and then this value increases each day, up to €69m on the 17th day. The period of trading prior to, and up to the end of Aug contributed to the brokers under-performance (when the green line is above the red line in the chart).

A Potential Explanation

The argument that has been made to us is that it is unlikely that the broker had €665m of naked share price risk right before the share price went ex-div. Apparently some contracts allow the broker to hedge their risk. It was suggested that the broker bought cum-dividend

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[1] Volume Weighted Average Price- VWAP is a popular equity execution benchmark.

[2] These "VWAP-minus" and similar products that reference this "bogus benchmark" are what we call "problem products". We have published many related articles and notes on issues relating to these products.

shares and kept them on their own account. The broker has a legitimate reason to hedge their risk as they have entered a contract with ING that requires them to guarantee certain outcomes. In principle we agree with the last part of this argument.

The explanation continued, that once broker had collected the dividend paid on the shares held in their own account, they then transferred the ex-dividend shares to the company. This transfer process is evidenced by the sudden spending increase shown in the chart immediately post the shares going ex-dividend. The price differential between where the broker bought and then sold their shares yielded a profit in this instance. But regardless of the direction that the share price might have moved, during the initial cum-dividend leg, the brokers risk of the share price moving would have been largely hedged. In this case the hedges profit offset the loss owed to the company through the contracts price guarantee, but it would have worked equally well if the share price had fallen during this period.

Where is the problem?

The broker has delivered on a performance guarantee to ING, which required them to pay a €66m fee. The dividend paid to the broker was in part reflected in the magnitude of the discount offered to ING and agreed in advance. It might be complicated, but there doesn't appear to any real problem, right?

What does the law say?

The law[3] says that it is market abuse for a company to buy its own shares. There are some special conditions, which if the issuers follow, then they can claim one of three exceptions. ING appear to claim exemption a) (Article 5.2 (a)) when they say that "The purpose of their buyback is to reduce the share capital on ING". We will not re-state the "sole purpose" case for potential market abuse beach relating to the forward price benchmark. We have already discussed this in our Diageo case study of the Oct '23 – May '24.

There may however be an additional breach in this ING case study that relates to their disclosures. The issuer is required to report ... "each transaction relating to the buy-back programme, including the information specified in Article 25 (1) and (2)... of Regulation (EU) No 600/2014"

This article 25 (1) relates to the broker maintaining records of "the relevant data relating to all orders and all transactions in financial instruments which they have carried out, whether on own account or on behalf of a client".

If the broker has purchased cum-dividend shares as a hedge which relates to the buyback programme, then the law seems to state that even if they were carried on the brokers own book they still need to be reported. There are no such reports of these trades as far as we can see. Regardless as to whether the details of the explanation for the specific trading behaviour in this case are correct or not. It seems highly unlikely that a broker would carry

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[3] Within ING's share buyback programme announcement, they state "The ECB has approved the programme, which will be executed in compliance with the Market Abuse Regulation and....". The laws they refer to are Article 5 EU Regulation No 596/2014

€665m of exposure to ING's share price with no hedge at all. As a result, ING may have failed to satisfy their requirements to report any broker hedge as required in Article 5.1 of 596/2014. If this is true, the whole programme may be in breach of market abuse rules.

Painting the Tape?

Secondary to this, and arguably a more minor point. If on the days after the shares went ex-dividend, the broker sold their long position into the market, and, at the same time purchased shares for the corporate. Then the broker is at risk of appearing to wash these trades though the market. If the intention is to transfer the hedge positions from the brokers own book to the corporate, then these trades are are not truly price forming. Nor are they liquidity that is truly available to the market, as any sells will effectively net off against a buy order. Or at least one part of one side, would net all the other side. This runs the risk of appearing to be what is known as "painting the tape". Certainly, the broker could make a case to say that any selling orders had a different execution benchmark to any buy order, or some other subtle difference. However, if the intention and the result was to affect the transfer of the shares from the brokers own book to ING then don't we need to think about the spirit of the law? The consequence of using the open market to move share positions from one book to another, both under the same brokers control, is that this practice gives other market participants the illusion of the share being more liquid than they are, which may have many other implications.

Conclusion

The execution of ING's 2023 share buyback raised another potential issue around compliance with market abuse rules. These potential issues relate to execution products that we refer to as "problem products". This case study has highlighted a possible lack of transparency around the broker's hedging trades. Additionally, if the broker sold their hedge into the market while buying for ING, it risks giving a misleading impression of liquidity or "painting the tape." While ING claimed an exemption, the lack of full disclosure around related trading could undermine meeting the conditions. This case highlights the need for a review of the transparency on all trading activity related to buybacks that we have proposed to regulators in the UK and EU.