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Summary of some of issues Candor Partners is highlighting in share buy-back execution

Introduction

When a company decides to do a share buy-back, the primary objective for the implementation of that decision is one of two things. Either to buy as many shares as possible for the value attributed to the buy-back (how many shares), or to efficiently transfer as much of that capital's value to the selling shareholders (how much value). These are clearly not mutually exclusive; however, we should evaluate both the strategy employed and the outcome of that strategy against one or both objectives to ensure that the board/management did their job of protecting their shareholders' interests.

Problem Products

There is a set of execution products that have been used in the market for at least 25 years, whose strategy and fee structure is designed to neither buy as many shares as possible, nor to efficiently transfer capital to shareholders. Their primary design is to out-perform an unusual execution benchmark. The broker's fee/profit is derived from the magnitude of any out-performance of this unusual benchmark. This means that in certain circumstances the broker is directly incentivised to both manage the share price risk and the trading activity in a manner that conflicts with the interests of the shareholders. All the details of these products are embedded in contracts which sit on the "private" side, and so the public side is completely unaware of these practices. We question if company boards, their management or advisors have enough equity execution knowledge to effectively govern these complex products used. A Prof. of Finance and I collaborated to write a white paper on this topic called "The Great Deception", where we detail the specific issues with these products.

Scale of the Issue

We estimate that over the last 5 years the total value of shares bought back in the US, EU and UK is ~$5.6 trillion. As a result of these problem products, we estimate that at the start of share buy-back programs executed via these products a cumulative total of $276bn worth of shareholder (VaR) Value at Risk has been managed improperly. We have not tried to estimate the actual cost of this risk mis-management, however we do estimate that these products have yielded an accumulated fee/pnl of about $8.5bn in this 5-year period.

Potentially Helpful Catalyst for Change

In May of this year the SEC approved the modernisation of some disclosure rules that relate to share buy-backs. We believe that our insights into these share buy-back products in the UK and EU will be catalysed by these transparency changes in the US, which our UK/EU insights have highlighted. On that topic you might find this article useful. We wrote this

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article to try to target the US legal community, especially company secretaries, with a goal of getting the attention of boards/management in the US.

Why does this all matter?

Let us set aside the shareholder losses for a second and look at the big picture. When you lower the frictional cost of transactions in high value markets a lot of positive things happen. We know this in theory, but also in practice. When we lowered the costs to trade shares in the UK/EU by introducing exchange competition (MiFID I) the diversity of market participants, the volume, velocity and types of trading (eg Dark), the market spreads and the overall cost of trading have all improved, most or all of this has been good for investors and issuers.

If we look into our crystal ball, we can see that when we lower the costs for corporates to transacting in their own shares this will encourage more issuers to come to market via IPOs (help lower number of listings decline) and increase the secondary market issuance (greater market capitalisation). If the UK can lead this, then that should be a net benefit for our market, our economy, and our nation (improving the chance that the next ARM chooses to list in the UK). Our Treasury and our Regulator have ambitions to improve the fairness and competition in our securities market. The changes proposed in this paper require absolutely no law or policy changes at all. They just require a market wide awareness and a change in approach to the governance of these transaction processes. Retail, institutions, hedge funds and sovereign wealth funds all pay single digit bps to trade in our issuer's shares. We know that there are great products that deliver very high-quality execution to the rest of the market. Why should we penalise our corporates, the ones whose securities we all trade in, with inferior products delivered at many multiples of the costs?

The oligopolistic banks will of course continue resist any disruptive change to our primary and secondary equity transactions. However, our capital market intermediaries rely on high degrees of trust to protect their franchises. When the flaws, scale and compounded effect of the damage caused by these buy-back products becomes understood by the market some of this trust will be eroded. Let's use this chance to open opportunities to drive badly need change to our capital markets system, enable a wave of innovation that already exists, but is starved of oxygen, to lead this change. Can you think of another section of our industry that has resisted technology/innovation as successfully as the primary and secondary equity issuance market?

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