Candor

Enhancing the Relative Competitiveness of the UK 's Equity Capital Market

Reducing Friction on UK plc's Capital Return Mechanism

Candor Partners response to HM Treasury's call for evidence: Financial Services Growth & Competitiveness Strategy

The listed UK equity market is currently perceived to be uncompetitive. A lot of work has been and continues to be done which is designed to help improve this. Candor Partners will provide evidence to shows that one of the reasons for the UK's continued competitiveness challenges relates to the frictional costs of transmitting capital from issuers back to investors via buybacks. In the UK it is approximately twice as expensive as the equivalent costs for a similar listed US firm to carry out a buyback of similar scale, i.e. in the US the total cost is estimated to be on average around 3% (Man Institute), and in the UK on average between 6 and 8%. We call this roughly 4% difference in costs between US and UK share buyback executions costs excess friction.

The reason why we should pay attention to this excess friction is because a little over 50% of MSCI UK companies have bought back over 1% of their shares in the last 12 months. This is the highest percent of any country index in the world (Chart 3). Approximately 50% of the £120 to £130bn of capital that UK listed firms currently return to their investors each year is via dividends, and the other 50% via buybacks. This excess friction reduces the total returns of investors in UK listed equity by c£2.5bn per annum (4% of £60bn). This lost return compounds over time, which if you calculate using the historical FTSE 100 total return of 7.4%, would be approximately £35bn additional investor returns over the next 10 years.

At the heart of the market, one of its core purposes is to efficiently transmit capital and risk between investors and issuers, and then recycle that capital back to investors when it is no longer required. If the frictional costs on transmitting that capital is significantly higher in the UK than other competitive markets like the US, then investors will continue to move their capital to markets where they risk adjusted returns are higher. When this happens, the current UK issuers, and future potential IPO candidates will follow these investors. There is abundant evidence that this process has been and continues to happen.

Sir Nigel Wilson's Capital Markets of Tomorrow discusses the need to make the UK's markets match fit and to reform corporate governance. The reform programme's narrative is focused on attracting new issuers and investors to the UK public and private markets.

This public market is an ecosystem. It is important to recognise that reducing the friction on the c. £120bn of issuers' capital that is recycled to investors each year will improve investors' returns on their UK equity investments. This increase in returns compounds with time, which is important for attracting new investors, such as a greater proportion of the UK pension funds.

Setting the Scene

An investor/asset manager owns a 10% shareholding in a UK-listed firm, which they plan to hold for many years to come. The issuer's board approves a capital return of £1bn to their shareholders this year. It is important that this investor receives their fair share of this capital regardless how the capital is returned to them.

This paper is not a commentary on the relative merits of how the capital is returned, whether it be via dividends, buybacks or both. Rather the paper chooses to focus only on the frictional loss to this capital as it is transmitted from the issuer back to the investor.

If the capital was returned via a dividend, this investor would receive £100m in cash (pre-income tax). If that capital was returned via a buyback, this remaining investor would, in effect, receive £100m worth of the repurchased shares. The interest of this investor is that the number of shares the issuer repurchases is greater, not lesser, so their ownership increases more this year. This means that next year, this investor will receive a larger portion of any capital to be returned due to their increased ownership.

3 Proposals for how to lower the cost of friction when capital is returned via buybacks

1. Change the disclosure laws for buybacks

In the US, disclosure laws only require a company to announce the board's approval of a buyback. In most instances, the next legally required disclosure is after any shares have been repurchased, not before they start. US companies report any buyback activity and progress on a delay, reporting monthly trading activity in their next quarterly report.

In the UK, when the issuer wants to act on the board's buyback permission, the issuer must a disclose the details of the programme's size and execution intentions before starting. Also, on the day following any share purchase (T+1), the issuer must disclose how many shares, at what prices, and on which venues the purchases were made.

In the UK, share buybacks are the single largest buy orders in the market, the size of the average FTSE 100 member's buyback programme is over £1bn and over 15 days of the stock's average daily turnover.

The combination of large programme size and high-level pre-trade and near-live execution disclosures provides significant value to other market participants. The net effect of this is that the share price is driven higher before the issuer can buy a single share. With the overall result being that this issuer repurchases less of their shares than an equivalent buyback done by an issuer in the US and other markets.

If the issuer buys back fewer shares, remaining shareholders receive less benefit from the capital return programme, with a significant portion lost to market friction.

In Europe, the disclosure laws are more favourable than the UK's. European issuers report daily trading activity for each week, effectively on a two-week delay. This longer delay between trading and its disclosure to the market, lowers the information's value to intermediaries, and so improves the outcome for issuers and their remaining investors.

Immediate transparency can create uncertainty when execution strategies change. Pausing trading for a few days may raise concerns about the issuer's status, potential news, or possession of material non-public information. This void of information driving the change in a previously observed trading pattern can cause increased share price volatility and speculation for no good reason.

Proposal 1 for the UK to consider

We propose delaying any buyback trading intention and daily trading activity disclosures for at least a quarter. The US SEC modernised the disclosure rules in the US this year. They passed new rules requiring issuers to disclose the daily trading activity of share buybacks on a delayed basis in their 10Ks and 10Qs. Although these rules were passed by the SEC commissioners, they were later overturned in the 5th Circuit Court of Appeals.

Here are two short articles on the topic of delaying disclosure reports: Jamie Dimon, the JP Morgan CEO's response when asked why JPM were putting their share buyback programme on hold earlier this year. FT OpEd on UK share buyback execution costs.

Benefit to the UK if proposal 1 is adopted

The UK has the highest level of disclosure globally. We believe that by implementing a delay, the UK would lower the cost for issuers by 30 to 50% while maintaining the world's highest standards of granular daily trading details used to execute share buybacks. These details have a positive side effect of enabling the market to carry out its own hygiene. This means that investors can, for example, check that any buyback is executed using a strategy that aligns with their interests, measure the execution quality, check for compliance with market abuse regs, etc. Current US disclosures do not allow their investors to do this, which negatively impacts US investors. By adopting this proposal, the UK would enhance its current level competitiveness versus the US and the EU.

A simple analogy is in the US when the companies come to the card table, they are allowed to keep their cards to their chest while playing their hand. In the UK the companies must reveal their cards to the table while they play their hand. US companies can therefore get better outcomes for their remaining shareholders, increasing their total returns, than UK firm can when executing buybacks.

2. **Revisit the current interpretation of the buyback safe harbour laws**

UK listed company share buyback programmes are typically large in value (>£1bn) and large relative to the daily turnover of the issuer's shares in the market (>15 ADV). Equity execution is expensive and increases with the size of an order and the time taken to execute it. Most share buybacks in the UK are executed "on-market" rather than via tender offers.

Most large "on-market" buybacks involve issuers contracting with investment banks for guaranteed or riskless principal execution benchmarked against VWAP (volume-weighted average price).
These contracts have some very useful operational benefits for issuers. These benefits include allowing the buyback to be executed through the issuer's closed periods as well as abstracting the daily trading decisions and complexities related to the safe harbour conditions of trading away from the issuer.

These contracted execution products are typically arranged so that the issuer only pays a fee if the execution price is lower than a so-called "VWAP" benchmark. This "VWAP" benchmark is not the conventional benchmark commonly used by investors when they buy and sell shares, but a special version unique to share buybacks. We have nicknamed this buyback version of VWAP the "bogus benchmark."

We will not cover all the problems with these products in this paper; however, we have written extensively on this topic. A paper called "The Great Deception," co-authored by Joerg Osterrider a Professor of Finance and Michael Seigne, is one of the foundations of our work on this topic.

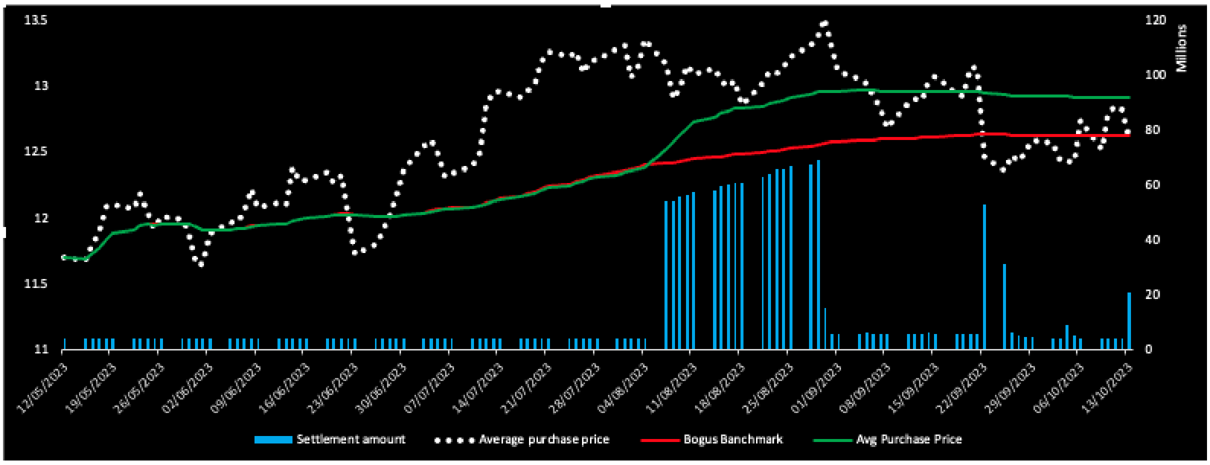
One of their core problems is that issuers mostly use Article 5, clause 1 (d) and 2 (a) to benefit from an exemption to market abuse and insider trading when implementing buybacks. This safe harbour law requires that the objective of the buyback execution be to reduce the issuer's capital.

These structured products use an execution strategy that aligns neither with the issuer's safe harbour exemption criteria nor with remaining shareholders interests. Part of the problem is caused by the design of the products execution performance driven fee incentive for the broker. The issuer typically pays or receives a fee based on the difference between the broker's average purchase price and this "bogus benchmark", creating a conflict between issuer responsibilities and broker interests.

There are many ways for the broker to "game" the execution performance against this bogus benchmark. For example, the broker has control over both the execution strategy and the benchmark setting window, usually within pre-agreed parameters. Typically, the broker will try to end the programme when the benchmark price is at its highest, not lowest price. This can result in the issuer incentivising the broker to buy fewer rather than more shares in certain situations.

They say that a picture can tell a thousand words, so this one chart of a share buyback execution might help show that something is not right with these products.

The chart below shows the trading pattern of a share buyback executed using one of these "VWAP-discount" based products. In this chart, the white dotted line is the daily share price, the blue bars is the value of shares the issuer purchased each day, and the red line is the “bogus benchmark”. On the 62nd day of this execution, the issuer disclosed that they spent roughly 14x more value buying shares than they had on any day prior. Note that on the 62nd day, the share price was also c. 12% higher than at the programme's start. From the 62nd day throught the 78th day the issuer disclosed that they spent more and more money each day, buying shares at these elevated prices relative to the days at the start of the programme. On the 79th day they revert to spending much lower values per day when the share price was at similar or lower prices.



This is not the trading behaviour expected from an issuer attempting to buy more shares per unit of money spent to reduce its share capital. In a more normal execution, investors try to buy more shares by spending more money on days when the share price is lower, not higher. Also note that the red line, the “bogus benchmark,” is at its highest at the end of the programme; this is not a coincidence either.

The catalyst for the change in spending behaviour appears to be the issuer's share price going ex-dividend, which occurs on the 62nd day. This unusual trading pattern around share prices going ex-dividend is observable in almost all share buybacks implemented using one of these “VWAP”-based products.

As seen from this chart, it is hard to reconcile this sort of trading pattern with either the exemptions in the safe harbours for market abuse or the issuer's fiduciary responsibility to their remaining shareholders. This strategy is optimised for something other than attempting to buy the greatest number of shares. These observations have also been made, completely independent from our work, by Stefan Schlamp, the head of quantitative analysis at Deutsche Börse.

The UK already has a better law in place than the US. As mentioned above, in the recent SEC’s attempt to modernise the US share buyback disclosure rules, one of these new rules required that US firms give stated rationales for each share buyback programme. The UK (and EU) already has this rationale embedded in their laws.

Proposal 2 for the UK to Consider

The existing law set out in the UK legislature, article 5, already covers what is required. It is the current interpretations that needs resetting. We propose that the FCA specifically state that for an issuer to benefit from this safe harbour, then the implementation of the share buyback should align with the intentions set out in the law. i.e., the execution strategy should attempt to optimise for the purchase of as many shares as possible, which these VWAP based time weighted forward price agreements do not solve for.

The FCA should make this clear immediately, possibly followed by a paper on the topic. The reason there is a critical time component is that UK issuers announce a new buyback programme almost every week. The UK's high transparency of daily trading data makes evidence of this behaviour readily available, potentially leading to legal action by disgruntled shareholders again UK firms for mishandling remaining shareholders interests.

It has also been noted by several large UK asset managers, that dividends normally require annual shareholder approval. Given the increased proportion of capital being returned to shareholders via buybacks, we propose that buybacks also require annual shareholder approval. This is important because returning capital via buybacks carries higher risk and complexity than dividends, as highlighted in this paper. An annual voting mechanism would enable shareholders to challenge a board's knowledge as to how any buybacks would be executed on their behalf prior to voting in their favour.

Benefit to the UK if proposal 2 is adopted

On average, UK issuers' remaining investors would receive a larger increase in ownership than issuers who implement a comparable share buyback on a foreign market. Boards of listed UK issuers would be at a reduced risk of class action suits due to a possible failure to protect the remaining shareholder's interests. The UK market would have a lower risk that share buyback execution strategies can be used to manipulate share prices. US and European listed firms will continue to be at this risk. See this article suggesting of such behaviour in US can engineer a short squeeze in share price.

3. Review and update the FCA's Conditions of Trading

For an issuer to benefit from the market abuse and insider trading safe harbour, they must follow a proscriptive series of steps in Article 5. One of those steps is that the issuer must have "adequate limits about price and volume", and the execution is carried out in accordance with conditions set out in some FCA technical standards. These technical standards were last revised in 2005 when the UK equity market had a very different structure to current times. In 2005, for example, there was only one UK-listed exchange and no competing trading venues.

The current interpretation of these rules limits an issuer and their broker from trading their buyback only on the lit continuous portion of the market. Issuers are also limited to a maximum of 25% of the historical volume on that venue on any given day. The portion of UK volume that now trades in the lit continuous market, of total volume that trades across all venues and phases of trading each day in the UK, is between 15 and 20%. This means share buybacks are limited to around 25% of 20% of volume. Or, said differently, a maximum of 5% of available liquidity that is available to an average investor. There is minimal benefit to these rules and numerous costs to this process.

One issue is that limiting the market's most oversized orders to only 5% of available volume forces an artificial extension of the time it takes to complete a share buyback. Increasing the time required to complete an equity order increases risk, and increasing risk increases expected costs, which the shareholders bear. Another is that the FCA's research finds that trading on venues with lower levels of pre-trade transparency has lower expected transaction costs for large orders, and the lit continuous market has the highest levels of pre-trade transparency. A third is that issuers are trying to repurchase shares from their shareholders. Forcing the shareholders to sell and the issuer to buy these shares through only the lit continuous market inserts intermediaries into these transactions. These intermediaries already have near-perfect transparency regarding the size, timing, and progress of very large buy orders and are well-positioned to extract a lot of value at the expense of shareholders.

The US's 10b-18 rules are very similar to the UK's "conditions of trading," and they need modernisation. Europe broadly shares the same conditions of trading as the UK.

Proposal 3 for the UK to Consider

Review or even remove the conditions of trading. The UK market abuse rules for all other participants are generally "principles-based" rules. The current conditions of trading in the technical standards are rules-based. We would propose that we revert to a more "principles-based" set of rules within our safe harbour for buybacks. If we remove the FCA's out-of-date "conditions of trading" technical standards, we think this solves that. The "new rules" would then read as in the current Article 5 clause 1(c): "adequate limits about price and volume are complied with". Since we already have highly granular daily trading disclosures, any concerns, such as if the share price is being manipulated, can be examined and challenged using this disclosed data (hopefully on a delay). There is no need for anything further, in our opinion.

Benefit to the UK if proposal 3 is adopted

Issuers are attempting to repurchase shares from their existing shareholders. By removing the prescriptive trading conditions, issuers and their brokers can leverage all the benefits of our modern market structure, like any investor trying to execute a large order. It will help issuers, and their brokers protect these orders from information leakage and reduce forced interactions with market intermediaries should they see fit. Regular investors can use a minimum fill quantity parameter to limit information leakage or can choose to accelerate the execution of their order via block trading venues without concern for causing market abuse. Why should issuers not be allowed the same privilege to execute their buyback orders? After all, they execute these buybacks for the benefit of their remaining shareholders. Increasing the flexibility for an issuer to control such parameters as the source of their liquidity, the style of execution, the rate at which they can execute, etc., should enable the issuers to align their buyback execution strategies with their remaining shareholder interests in a superior manner to their global peers. Thus, lowering the average transaction costs and risks borne during the execution of these buyback orders. Another benefit is that all brokers could compete equally for issuers share buyback executions. This would bring all the benefits of competition and the developments in execution quality to issuers, which aligns with what has been available to investors for many years.

Conclusion

Lowering the frictional costs for transacting buybacks in the UK is straight forward. We believe this will help to increase the total return for long-term investors in publicly listed companies. A higher total return will help to attract more investors to UK public markets, which in turn will, help to attract more IPOs to the UK.

Making the UK the most competitive market in the world for issuers to return capital to their investors is part of Sir Nigel Wilson's vision for the UK's Markets of Tomorrow. How can the UK have the best functioning, match-fit, and best corporate governance without it?

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Candor Partners Limited offers a consultancy service to help corporates execute listed market transactions efficiently and regulatory-compliantly, with a deep focus on share buybacks. This service is also designed to help boards discharge their governance responsibilities throughout the implementation phase of these large capital allocations. We help marry objectives with outcomes, estimate transaction costs, guide execution strategies, and then measure and evaluate the results. Ultimately, the goal is to enable the efficient transfer of capital from issuers back to their investors to increase total returns.

