No. 23-60255

In the United States Court of Appeals for the Fifth Circuit

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA ET AL.,
Petitioners,

v.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
Respondent.

Petition for Review of an Order of the Securities and Exchange Commission

BRIEF FOR S.P. KOTHARI AND JAMES OVERDAHL
AS AMICI CURIAE IN SUPPORT OF PETITIONERS

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INTERESTS OF AMICI CURIAE

Amici are former SEC Chief Economists James Overdahl and S.P. Kothari.[1] Dr. Overdahl is now a partner at Delta Strategy Group, where he provides economic advice and analysis in business, legal, and regulatory matters. Professor Kothari is now Gordon Y. Billard Professor of Accounting and Finance at MIT's Sloan School of Management. In January 2023, Professor Kothari coauthored an article empirically examining rationales for stock repurchases and rebutting common criticisms. *See* Nicholas Guest, S.P. Kothari & Parth Venkat, *Share Repurchases on Trial: Large-Sample Evidence on Share Price Performance, Executive Compensation, and Corporate Investment*, 52 Fin. Mgmt 19 (2023), https://tinyurl.com/2je74hfw ("Kothari article"). Commenters discussed the article during the notice-and-comment process and the SEC discussed it in the Rule. Dr. Overdahl and Professor Kothari are experts on both the SEC's regulatory requirements and the economics of share repurchases.

[1] Pursuant to Federal Rule of Appellate Procedure 29(a)(4)(E), counsel for *amici curiae* state that no party's counsel authored this brief in whole or in part, and that no person other than *amici curiae* or their counsel contributed money that was intended to fund preparing or submitting this brief. All parties have consented to the filing of this brief. *See* Fed. R. App. P. 29(a)(2).

INTRODUCTION

While the SEC premised its share-repurchase rule on two economic justifications—asymmetric information between insiders and external stakeholders and the potential for opportunistic use of share repurchases by management—the SEC has failed to provide any credible support for these justifications, in our view, and has relied on a selective review of the economic evidence. On the cost side, the SEC has not adequately considered economic evidence demonstrating the potentially harmful economic consequences of the Rule on efficiency, competition, and capital formation. And on the purported benefits side, the SEC has failed to adequately consider record evidence showing the economic benefits of share repurchase programs. By failing to adequately consider economic evidence addressing the economic consequences of the Rule, the SEC has severely underestimated both the Rule's immediate costs and broader economic consequences.

For these reasons, we support the petition to review and vacate the Rule.

SUMMARY OF ARGUMENT

There is nothing remotely nefarious about share repurchasing. When a company *issues* shares, it is taking in cash and sending out equity. A share repurchase is simply the reverse—the company sends out cash and takes back equity. Companies therefore issue shares when they need cash and repurchase shares when

they have excess cash. And when companies can issue and repurchase shares freely, investors can take cash from companies that have exhausted profitable investment opportunities and reallocate that cash to companies that do have profitable investment opportunities and need cash accordingly. By reallocating cash to more productive use, share repurchases promote investor wealth, economic efficiency, and capital formation. The SEC has never contested the benefits of share repurchasing, and indeed acknowledged many of them when promulgating the Rule.

The SEC nevertheless asserted that the Rule is necessary to address the *theoretical possibility* that some repurchases could harm investors, but the SEC cited no evidence that suboptimal repurchases actually occur with any regularity. The SEC's view is that we do not know if suboptimal share repurchases occur systemically, and the Rule's exceedingly costly disclosure regime is the way to find out. Not only does that flip the burden from the SEC to the regulated public, it also disregards plentiful evidence in the economic literature that there is *no* systemic abuse of share repurchasing. Professor Kothari's large-sample study published this January, for example, tested hypotheses of systemic abuse and found no evidence supporting them.

On the other side of the ledger, the Rule imposes enormous costs. The Rule not only creates substantial compliance costs but also will likely harm investors—particularly retail investors—by creating needless noise in the set of information

they must evaluate. By abandoning the usual materiality standard for corporate disclosures, the Rule will drown investors with information they cannot meaningfully discern. And the Rule creates competitive harm by requiring companies to disclose sensitive information.

ARGUMENT

The Securities and Exchange Act of 1934 ("Exchange Act") requires the SEC to "consider or determine whether an action is necessary or appropriate in the public interest" and whether "the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f). The Exchange Act also prohibits the SEC from adopting any rule that would "impose a burden on competition not necessary or appropriate in furtherance of the purposes of this chapter." *Id.* § 78w(a)(2). The SEC therefore has an obligation to determine "as best it can" the "economic implications" of its rulemakings. *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005); *see also* SEC, Current Guidance on Economic Analysis in SEC Rulemakings 5 (2012) (requiring the SEC to clearly identify the justification for proposed rules). Failure to consider the "economic consequences of a proposed regulation"—its costs and benefits—makes a rule arbitrary and capricious. *Bus. Roundtable v. SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011); *see also* 5 U.S.C. § 706(2)(A). Here, we agree with Petitioners' argument that the Rule is arbitrary and capricious because there are substantial costs and no discernable benefits.

A. The SEC Failed To Identify A Market Failure Justifying The Rule

The SEC failed to point to any market failure associated with share repurchasing, which is an unexceptional tool used to efficiently reallocate cash when a company has more than it can profitably use. The SEC rested on the possibility that repurchasing *could* be abused, but as Professor Kothari and others have shown, empirical evidence reveals that the potential abuses the SEC invoked do not *actually* occur.

1. Share Repurchases Benefit Investors And The Economy, As The SEC Itself Acknowledged

In general, share repurchases undeniably increase investor wealth and promote capital formation. Share repurchases are a profit-maximizing company's ordinary and natural response to shifting cash needs. Sometimes a company's cash flow is on target; sometimes a company has too little cash; and sometimes a company has too much cash (*i.e.*, more than it can efficiently use). Share repurchases address that last scenario.

To put it in slightly more technical terms, share repurchases prevent a company from reducing shareholder value by overinvesting—that is, investing in projects that earn less than their opportunity cost. Suppose a company has cash inflows that exceed its operating costs and debts. A value-maximizing company will first allocate that cash to new and existing investments that increase firm value.

Once a company fully invests in all projects that have a positive net present value, however, any further investment would reduce the company's value. Rather than make value-destroying investments, value-maximizing companies return surplus cash to shareholders.

A share repurchase, then, is simply the inverse of a share issuance. When a company needs *more* cash, it may issue shares—the company gives investors pieces of ownership in the company, and in exchange receives cash from the investors. When a company has *too much* cash, on the other hand, it may purchase back shares—the company takes back pieces of ownership, and in exchange sends cash to the investors. Either way, conceptually the transaction is value neutral—there is an exchange of cash for shares of corresponding value. *See* SEC, Open Meeting (May 3, 2023), https://perma.cc/T7QZ-F9FJ (Chair Gensler describing repurchases as "merit neutral"). Following a share issuance, the value of existing shares is diluted but the company now has more cash. Following a share repurchase, inversely, the company now has less cash but existing shares are worth more. *See* SEC Staff, *Response to Congress: Negative Net Equity Issuance* 4 (2020), https://perma.cc/ZK6M-55LK ("SEC Staff Study") (a "long-standing conclusion in academic finance literature" is that in an efficient and undistorted market, share repurchases do not "affect the market value of the firm beyond the amount of capital returned"). And no one is ever coerced into any of these transactions—just like

investors choose to purchase shares a company issues, they likewise choose voluntarily to sell shares a company repurchases. Repurchases represent arm's length transactions at prevailing market prices between willing participants. And while companies can also return excess cash to shareholders through dividend payments, at times share repurchases are preferable to dividends in important respects—for example, because of certain tax advantages and because of greater flexibility in determining the amount of cash returned. *See* Kothari article at 2, 11.

Shareholders can use the cash they receive in a repurchase to invest in other companies that need to raise additional cash for investment opportunities that are value increasing. That benefits not only those other companies but also the shareholder—investors often use the cash they received from a share repurchase to reinvest into growing companies that will provide higher returns. By allowing surplus cash to find more productive use, economy-wide corporate investment is more efficiently allocated to shareholder benefit.

The SEC has disputed none of this. Rather, the SEC acknowledged that share repurchases "provide an avenue for returning capital to investors, which may be efficient if the issuer has cash it cannot efficiently deploy." Rule at 13; *see also id.* (repurchases "are often employed in a manner that may be aligned with shareholder value maximization"). Repurchases also have "unique features that are not easily replicated through dividend payments," the SEC admitted. *Id.* at 13–14. And

repurchases "can provide a relatively credible signal of the issuer's view that its stock is undervalued." *Id.* at 14; *see also id.* at 13 (repurchases "send signals to investors that managers are operating the issuer efficiently rather than retaining excess cash for potentially suboptimal use").

2. There Is No Evidence Of Systemic Abuse Of Share Repurchasing

The Rule is regulation in search of a problem—the purported ills it claims to address simply do not exist. Because of share repurchasing's undisputable benefits, the SEC was forced to attempt to justify the Rule on the thrice-hedged assertion that repurchases sometimes "may" be influenced "in part" by "potentially" suboptimal reasons. Rule at 14.

Even the SEC's timid and speculative claim, moreover, is refuted by the record evidence. The SEC asserted that according to "[s]ome research" in certain cases "issuers that would have narrowly missed an earnings per share ('EPS') target were more likely to have engaged in repurchases." Rule at 14–15. And the SEC asserted that because "[s]ome studies" have "found personal trading by insiders close in time to predictable changes in share price caused by repurchases," equity-based or EPS-tied compensation arrangements "could potentially" be "one factor" that "may" influence "some" repurchasing decisions. *Id.* at 15–16. But Professor

Kothari's recent article, which was discussed by commenters and cited in the Rule, refutes those assertions.

As his study demonstrates, the evidence one would expect to see if repurchases were associated with widespread earnings manipulation or other fiduciary breaches does not exist. *See generally* Kothari article. If repurchasing abuse is sufficiently widespread to justify a costly nationwide rulemaking, the abuses should be readily observable in public data. But they are not. *See id.* at 24–25 ("[W]e do not observe much if any correlation"—"not to mention causality"—"between share buybacks and the alleged malpractices.").

If naive investors are tricked into buying shares of repurchasing firms due to EPS manipulation, for example, we should observe short-term price bumps followed by long-term reversion. But Professor Kothari found no widespread evidence to support this hypothesis—regardless of how often a company repurchases shares, his study found no evidence that firms significantly outperform in the quarters with repurchases. *See id.* at 4, 13–17. For the vast majority of companies, earnings manipulation is not even possible either because they do not have EPS-linked targets or because their boards considered the impact of repurchases when determining whether performance targets were met. SEC Staff Study at 7; *see also* Rule at 14 n.32. With respect to the remainder, even assuming these companies made EPS a primary consideration in compensatory awards, no study has suggested that they

"would have needed to repurchase shares to achieve an earnings bonus threshold." Craig M. Lewis & Joshua T. White, Comment Letter on Proposed Rule on Share Repurchase Modernization 18 (Oct. 7, 2022), https://perma.cc/BB7Z-255A ("Lewis & White Comment").

Similarly, if manipulating repurchases to increase compensation for CEOs were a common and systemic abuse, CEOs who use repurchases would receive abnormally higher pay. But CEOs of companies that make large repurchases earn a statistically insignificant amount of excess pay relative to CEOs of firms that do not repurchase. Kothari article at 4–5, 17–21; *see also* PricewaterhouseCoopers, Share Repurchases, Executive Pay and Investment 7 (2019), tinyurl.com/454yau2k (the correlation between share repurchases and executive compensation is not statistically significant and from 2007–2017 not a single FTSE 350 issuer "successfully used share repurchases to beat its EPS target").

Other commentators have reached similar conclusions: "the total number of buybacks where managers may have been intending to mislead investors, while non-zero, … appears to be limited." Lewis & White Comment at 17. These studies show that repurchasing is a mainstream corporate financial activity that does not harm shareholders. The SEC asserted that the new disclosures will provide investors with "additional insight … that they can use to evaluate the efficiency of and motives for the issuer's share repurchases," Rule at 55–56, but that could be said of any number

of a company's decisions. While investors cannot be certain that "every decision regarding a research and development project and or capital investment," for example, "is efficient and undertaken with pure motives," "the antidote is not requiring companies to describe in painstaking detail every corporate action." Comm'r Hester M. Peirce, *No Repurchase Left Behind: Dissenting Statement on Share Repurchase Modernization Rule* (May 3, 2023), tinyurl.com/4dvuypy9. The same is true for share repurchasing.

The SEC dismissed arguments of commentators who contributed to the rulemaking record on the extent of conflicts of interest motivating share repurchases. In dismissing these arguments, the SEC asserted that commentors had failed to establish that it is theoretically impossible for a share repurchase to be motivated by self-interest. *See* Rule at 17 (asserting that **"**the research cited by opposing commenters" does not undermine the proposition that self-interest "may be a factor" in determining whether to undertake a share repurchase); *id.* at 18 (opposing commenters did not show that self-interest is never "a consideration"); *id.* (Rule is necessary to alert investors to "the possibility" that a repurchase is motivated "in part" by self-interest). But the public does not bear the burden of establishing that abuse could never happen—rather, the SEC bears the burden of showing that repurchasing is in fact abused with at least some degree of prevalence. According to the SEC, the mere "opportunity" for accounting manipulation or improper insider

trading, and purported evidence that suboptimal repurchases have occurred before in history, are enough to justify the Rule. *Id.* at 23. But our age-old knowledge that "men [are not] angels," Federalist No. 51, cannot alone sustain industry-wide regulation, and the SEC pointed to no credible evidence of systematic abuse. *See* Kothari article at 16 ("[R]egardless of the managers' motivation for share repurchases, the evidence shows they neither generate a noticeable, long-term price appreciation nor do they dissipate firm value.").

Moreover, the SEC failed to consider whether the asserted problem that "some" repurchasing decisions "could potentially" be suboptimal could be adequately resolved with case-by-case enforcement actions focused on particular instances of abuse rather than a prescriptive rule that imposes costly burdens on all companies at all times. The SEC must assess its rules against "the existing regime," *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 179 (D.C. Cir. 2010), and assess costs and benefits "at the margin" of that regime, *Bus. Roundtable*, 647 F.3d at 1151. Here, the existing regime allows the SEC to bring an enforcement action against a company that repurchases shares for improper reasons—companies generally are subject to antifraud liability under the Exchange Act. *See* 17 C.F.R. § 240.10b-5; *see also, e.g.*, *In re Andeavor LLC*, Exchange Act Release No. 90208, 2020 WL 6112215 (Oct. 15, 2020) (enforcement action for improper accounting controls to prevent managerial abuse in repurchase program). The SEC offered no explanation

for why enforcement actions are insufficient to address any isolated instances of repurchase misbehavior.

Additionally, the SEC did not adequately address the fact that multiple safeguards already limit improper repurchase behavior. For example, firms typically disclose repurchase plans at the time they are authorized by the board of directors, and Regulation S-K Item 703 requires companies to disclose quarterly information about intended and completed repurchases, 17 C.F.R. § 229.703. The SEC admitted that this quarterly data allows shareholders to reach "informed conclusions" on "when repurchases have helped an issuer hit an EPS target." Rule at 52. The vast majority of issuers subject to this quarterly disclosure regime voluntarily disclose repurchase programs in advance. *See* Jacob Oded, *Why Do Firms Announce Open-Market Repurchase Programs?*, 18 Rev. Fin. Stud. 271, 271 (2005). And in open market repurchases—which represent ninety percent of repurchases by dollar volume—the market is informed of the size and duration of the repurchase once it is approved by the company's board of directors. Lewis & White Comment at 4. The SEC did not explain why these existing guardrails cannot handle any anomalous suboptimal repurchases.

The SEC separately invoked purported "information asymmetries" as a justification for the Rule, *see* Rule at 20, but that basis is just as flimsy. Asymmetric information between insiders and external investors is present in all market settings

and cannot be characterized as a market failure absent a negative outcome. Lewis & White Comment at 2. And limited information asymmetry can benefit investors by incentivizing market analysts to invest in information collection. *See* Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 Am. Econ. Rev. 393, 393 (1980); U.S. Chamber of Commerce, Comment Letter on Proposed Rule (Apr. 1, 2022), https://tinyurl.com/mpwet6ke (citing Lewis & White Comment). The Rule did not link the existing level of information asymmetry to any negative outcome for shareholders; the SEC instead relied again on the mere possibility that an adverse outcome could occur in some instances. *See* Rule at 145 ("[I]nformation asymmetry between issuers and investors . . . *may* lead to more informationally efficient prices . . . [and] *may* also incrementally facilitate capital formation and reduce the cost of capital." (emphases added)); *id.* at 99 (much of the agency's economic analysis discussion "remains qualitative in nature").

B. The Rule Will Impose Substantial Costs

As the Rule itself acknowledges, the Rule "will impose costs on issuers (and therefore existing shareholders)." Rule at 135. The SEC did not fulfill its obligation to quantify those costs, *see* Pet. Br. at 39–42, but they almost certainly will be immense. And the Rule will not merely harm shareholders by harming the

companies they own—it also will likely harm them directly by overloading them with immaterial information.

1. The Rule Will Impose Substantial Costs On Companies

Most obviously, the Rule will impose substantial compliance costs. *See* Rule at 135 ("The costs of the [Rule] include direct (compliance-related) costs to compile and report additional disaggregated repurchase data."). The SEC failed to quantify those costs, *see* Pet. Br. at 39–42, but they likely will be substantial. The significant compliance costs that the Rule will impose on smaller issuers in particular may force many to exit the public markets entirely. *See* Lewis & White Comment at 8. And the regulatory burdens the Rule imposes will likely lead many firms to forego otherwise efficient capital-allocation decisions, reducing shareholder value and raising agency costs. *See id.* at 9.

As the SEC also recognized, the Rule additionally will likely impose competitive harms on companies by requiring them to "shar[e] sensitive information with competitors." Rule at 135. Indeed, in general "one of the largest indirect costs of disclosure is the revelation of proprietary information to outside parties." Lewis & White Comment at 13. Here, the Rule's rationale and objective disclosures will indirectly reveal the discloser's competitive activities regarding strategic investments, acquisitions, research and development, and capital expenditures. *See id.* at 13–14; Dissenting Statement of Commissioner Peirce (the required disclosures

"could publicly release confidential information, including, in narrow cases, pending merger or acquisition activity or other confidential corporate actions"). This harm will be especially pronounced for companies in industries where capital-deployment strategies are crucial to value creation, such as financial institutions. *See* Lewis & White Comment at 13–14.

2. The Rule Will Likely Impose Substantial Costs On Shareholders Directly

While usable disclosures are essential to thriving capital markets, the granular repurchase disclosures required by the Rule will likely harm shareholders by overloading them with immaterial information. That is both because of the granularity of the required disclosures and the Rule's abandonment of the materiality standard that generally governs financial disclosure requirements.

The SEC materiality standard is the "bedrock of corporate reporting." Lewis & White Comment at 4; *see also id.* (materiality standard "limit[s] issuer disclosure obligations to information that would be of importance to investors"); SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 12, 1999) (outlining the SEC's materiality standard). "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (1976). If a materiality standard is "unnecessarily low," therefore, "not only may the corporation and its management

be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholders in an avalanche of trivial information." *Id.* at 448. That result "is hardly conducive to informed decisionmaking." *Id.* at 448–49.

Yet in this Rule, the SEC abandoned the materiality standard. The SEC reasoned that *every* repurchase is informative because of its timing. Rule at 57. But because there is nothing nefarious about repurchasing, *see supra*, the mere fact that a company repurchased shares on a given date is not inherently material. And Lewis & White extensively studied the materiality question and determined that "most daily repurchases would likely be deemed immaterial" under the usual materiality standard. Lewis & White Comment at 6.

By abandoning the materiality standard, the Rule's required disclosures likely will inundate investors with immaterial information that will drown out the material. Scholars have often found that granular repurchase disclosures are unhelpful and lead to information overload for investors. *See, e.g.*, *id.* at 9. Because "a wealth of information consumes attention," an investor inundated with immaterial information may be "distracted from value-relevant disclosures." *Id.* at 10. Here, moreover, the required disclosures could particularly overload ordinary investors and disadvantage them versus sophisticated market participants. *See id.* at 14 (because sophisticated investors "have better technology and resources than ordinary investors to process

and mine a large volume of . . . daily disclosures to identify any trading opportunities," the Rule "will create trading advantages for sophisticated investors while retail and other ordinary investors will be overwhelmed by the volume of these disclosures").

3. The SEC Failed To Consider Lower-Cost Alternatives

The SEC rejected several lower-cost alternatives without adequate consideration. For one, the SEC could have required companies to discuss the link between compensation and EPS-based bonuses in the Compensation Discussion and Analysis section of their proxy materials. Lewis & White Comment at 19. The SEC declined this more inexpensive route on the ground that it would not allow investors to "identify which repurchases may have been affected by managers' incentives … [and] would also fail to identify instances in which issuers or their managers are driven by other concerns, such as internal EPS targets." Rule at 53 n.196. But as discussed, the potential for managerial malfeasance cannot justify the Rule because there is no evidence that any malfeasance is prevalent.

Commenters also suggested that the SEC avoid the Rule's costs by simply issuing guidance detailing when repurchase disclosure is warranted to avoid an adverse enforcement action. *See* Lewis & White Comment at 7. The SEC failed to explain why it rejected that option, and that makes the Rule arbitrary and capricious. *See Industrial Union Dep't, AFL-CIO v. Hodgson*, 499 F.2d 467, 475 (D.C. Cir.

1974) (agency acted arbitrarily and capriciously by failing to explain why it chose to "follow one course rather than another" proposed by commenters); *Independent U.S. Tanker Owners Comm. v. Dole*, 809 F.2d 847, 852 (D.C. Cir. 1987) (requiring agencies to explain "why alternative measures were rejected").

CONCLUSION

We support the petition to review and vacate the Rule.

Respectfully submitted,

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July 17, 2023

CERTIFICATE OF SERVICE

I certify that on July 17, 2023, I caused the foregoing to be served upon all counsel of record via the Clerk of Court's CM/ECF notification system.

/s/ Megan Brown
Megan Brown

CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Fed. R. App. P. 29(a)(5) and 32(a)(7)(B) because this brief contains 4,146 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(f).

This brief also complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word for Windows, version 10 in Times New Roman font 14-point type face.

July 17, 2023

/s/ Megan Brown
Megan Brown