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# CRITICAL ANALYSIS OF MODERN BUYBACK REGULATION AND ITS IMPACT ON SMALL SHAREHOLDERS

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## Historical Context and Evolution of Buyback Regulations

Previously, share buybacks were more regulated because of concerns over market manipulation. Before 1982 in the United States, stock repurchases were criticized as a form of market manipulation. Starting in 1982, the U.S. Securities and Exchange Commission (SEC) established Rule 10b-18, offering a safe harbor for companies to conduct buybacks without being charged with market manipulation so long as they adhere to certain conditions[2].

Likewise, in other jurisdictions such as the European Union and India norms concerning buybacks began to become more relaxed over time focusing following a principle that corporations be given enough leeway for capital structuring. Even so, these regulations existed to prevent abuse as well and more importantly protection for minority/small shareholders from unfair practices[3].

## Role of Buyback

1. **Capital Efficiency** – Companies typically do buybacks when they have excess cash but no high-return investment opportunities. If they repurchase shares, the company can boost return metrics (such as EPS or ROE for instance)[4].

[1] Students at Amity University, Kolkata
[2]Admin,History of Buybacks (3 oct, 7:00 PM), https://treasurydirect.gov/research-center/history-of-marketable-securities/buybacks/
[3]Ibid
[4]James Royal, what are stock buybacks and why do companies use them? (3 Oct, 8:30 PM), https://www.bankrate.com/investing/stock-buybacks/?tpt=a

2. **Stock Price Support** - Those things could include signalling to investors that a business is so sound it can buy back its own stock, as well as propping up shares in turbulent markets.
3. **Tax Efficiency** – In case of stock buyback, it allows shareholders to choose when they can incur capital gain tax unlike in case of dividends which are taxed as income for shareholders[5].
4. **Management Incentives** – Executive compensation is often tied to stock performance, and buybacks can temporarily inflate share prices, benefiting insiders with stock options or equity-based compensation packages[6].

**Features of Modern Buyback Regulations**

Modern Buyback regulations mainly focus on ensuring transparency, avoid market manipulation and most importantly protection of small shareholders. Some of its key features include.

1. **Price and volume Restrictions**: Some regulations like Rule 10b- 18 in the US, limit the volume of shares that can be repurchased and the prices at which the company can buyback its own shares[7].
2. **Non-discriminatory Frameworks**: Most regulations mandate that buybacks must use the open-market method, making it possible for all shareholders (majority and minority) to sell their stocks. But of course, this supposes an efficient market and equal information to all, which does not really happen at least for small shareholders[8].
3. **Anti-Manipulation Protections**: SEC and other agencies point out anti-manipulative protections, but critics worry that buybacks can still be conducted for a purpose of manipulating stock prices especially if it is linked with the company's employee compensation plan[9].

**Impact of buyback on Small Shareholders**

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[5]Ibid
[6]Ibid
7 Ali Ragih, The SEC's New Corporate Stock Buyback Requirements Are Good for Investors (4 Oct, 8:21 PM), https://verityplatform.com/resources/the-secs-new-corporate-stock-buyback-requirements-are-good-for-investors/
8 Ibid
9 Ibid

**Advantages of Small Shareholders**

1. **Stock Price Appreciation** - Because buybacks limit the quantity of shares, they might cause stock prices to rise immediately, which may help small shareholders who hang onto their shares[10].
2. **Increased EPS and Dividends** - A lower share count usually results in greater EPS and maybe bigger dividends, which raises the value of a share for the remaining shareholders.
3. **Liquidity Opportunities** - Buybacks offer a way for small owners who want to sell their shares to the company again, frequently at a price higher than the market value[11].

**Disadvantages of Small Shareholders**

1. **Asymmetric Information** - Institutional investors and business insiders frequently have greater access to knowledge about the company's long-term prospects and financial health than small owners, which enables them to schedule sales more effectively[12].
2. **Short-term Stock Price Manipulation** - Buybacks have the potential to momentarily raise stock prices, giving the public a false sense of how well the company is performing. Small shareholders could be duped into making less-than-ideal investment choices because they lack the resources to perform in-depth research[13].
3. **Opportunity Costs** - Cash that could be reinvested in expansion prospects and yield greater long-term value for shareholders is diverted by buybacks. Particularly small owners may Favor reinvestment of dividends over a brief increase in stock price.
4. **Concentration of Ownership** - When businesses buy back shares, ownership may get more concentrated in the hands of large investors and insiders. This can dilute the voting power of small shareholders and reduce their influence over corporate governance decisions[14].

## LEGAL FRAMEWORK FOR BUYBACK IN INDIA

10 Admin, What Is Share Buyback/Repurchase? (5 Oct, 6:20 PM), https://wealthdesk.in/blog/what-is-a-share-buyback/
11 Ibid
12 Ibid
13 Admin, What Is Share Buyback/Repurchase? (5 Oct, 6:20 PM), https://wealthdesk.in/blog/what-is-a-share-buyback/
14 Ibid

The Securities and Exchange Board of India (SEBI) (buy-back of securities) regulations, 2018 and the Companies Act, 2013, together form the main regulatory framework in India that governs buybacks. Investor interests are safeguarded, and openness is ensured by these measures.

**COMPANIES ACT, 2013**

Share buybacks are subject to regulations set forth in the Companies Act of 2013, which aims to protect shareholders' interests and preserve financial stability. The legislation establishes prerequisites for authorization, buyback quantity ceilings, needed financial compliance, and time constraints for buybacks to guarantee that companies do not endanger their financial stability through the repurchase process.[15]

**Section 68 of the Companies Act, 2013 the conditions for Buy-back of shares are-**

- Articles must be authorized; if not, they may be amended by a special resolution adopted at a general meeting.
- A Special Resolution must be voted in the General Meeting in order to approve the buyback; however, if the buyback is up to 10%, a Board Meeting Resolution must also be approved[16].
- A financial year's maximum number of shares that can be repurchased is 25% of the shares' paid-up capital.
- A financial year's maximum number of shares that can be repurchased is 25% of paid-up share capital plus free reserves (paid-up share capital comprises equity and preference share capital, while free reserves include securities premium).
- After buyback, the debt-to-equity ratio can't go above 2:1.
- In a fiscal year, only fully paid-up shares are eligible for return.
- The company must notify the Register of Companies of its insolvency by filing Form SH-9, which must be signed by at least two directors, one of whom must be a managing director, if any[17].

15 Companies Act, 2013, (22 September 2024, 7:51 PM), https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf
16 Ibid
17 Companies Act, 2013, (22 September 2024, 8:01 PM), https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf

- An explanation statement declaring that all relevant facts would be fully disclosed will be included with the notice of the meeting where the Special Resolution is proposed to be enacted –
  1. The buy-back requirement.
  2. The category of shares that are meant to be repurchased.
  3. The total amount contributed to the buyback.
  4. The deadline for finishing the buyback.
- The business needs to keep an updated Register of Buybacks using Form SH-10.
- Submit the return of the buyback in Form SH-11, annexed with the compliance certificate in Form SH-15, signed by two directors, one of whom must, if any, be the managing director.
- Within seven days of the repurchase being completed, a company should physically destroy and extinguish the shares that were purchased back[18].
- Adhere to a six-month cooling-off period, meaning that no new share issues are permitted.
- The repurchase must be finished within a year of the date the Special Resolution or Board Resolution, as applicable, was passed.
- A corporation is not permitted to make a buyback offer within a year of the closing of the last buyback offers[19].

**Section 69 of the Companies Act, 2013 –**

- A sum equivalent to the shares' nominal value must be deposited to the Capital Redemption Reserve Account when a company brings back shares from free reserves or the securities premium account, per Section 69 of the Companies Act of 2013. The balance sheet will disclose the specifics of this transfer.
- Members may get unissued company shares as fully paid bonus shares by using the Capital Redemption Reserve account[20].

**Section 70 of the Companies Act, 2013**

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18 Ibid

19 Ibid

20 Surabhi Kumari, BUY-BACK OF SHARES AND SECURITIES, (22 September 2024, 8:17 PM), https://www.icsi.edu/media/filer_public/01/b1/01b1cde0-b7ec-4e60-b1d3-cb87ed01774a/article_on_buyback.pdf

A company is prohibited from buying back its securities or other specified securities under Section 70 of the Companies Act of 2013 in the following ways:

- Through any subsidiary, including its own subsidiaries.
- Through an investment company or group of investment companies; or
- When the company has fallen behind on payments for deposits or interest due on those deposits, or in the redemption of preference shares or debentures, or in the repayment of any term loan.
- If the default has been corrected and three years have passed since the default ceased to exist, the prohibition is lifted.
- When the company fails to file its annual report, dividend declaration, and financial statement on time[21].

**SEBI'S ROLES AND REGULATIONS**

To safeguard investors, maintain market transparency, and encourage the growth of the securities industry in India, SEBI (Securities and Exchange Board of India) is essential. Many facts of the financial markets are covered by its responsibilities and rules, with a focus on listed businesses, stock exchanges, and intermediaries.

There are two primary buyback mode available in India under SEBI regulations:

- **Tender offer method:** Under this approach, the repurchase is accomplished by means of a letter of offer that the business sends to its shareholders, offering a specific price within a specified time frame. With this approach, the business directly offers shareholders the chance to buy a predetermined number of shares at a predetermined price[22].
- **Open market offer method:** This approach uses the stock exchange system to facilitate buybacks. Up to a certain price, which is set by the corporation, shares may be repurchased at any price. In this case, the share price is not set. To compensate the current shareholders, the corporation often chooses to make an open market offer[23].

21 Ibid
22Pratheeka Varanasi, The Buyback Regulations In India (25 September,2024, 2:30 PM), https://www.legalserviceindia.com/legal/article-13141-the-buyback-regulations-in-india.html#google_vignette
23 Ibid

**REGULATION 4 OF SEBI (BUYBACK OF SEURITIES) REGULATION, 2018**

- The maximum buy-back limit is set at twenty-five percent or lower of the company's aggregate paid-up capital and free reserves, based on either the standalone or consolidated financial statements, whichever reflects a lower amount. In terms of the number of equity shares repurchased in a fiscal year, the maximum limit is twenty-five percent of the total paid-up equity share capital of the company in that financial year.
- The company's total secured and unsecured debts in relation to the paid-up capital and free reserves after buy-back must not exceed a 2:1 ratio, as per the standalone or consolidated financial statements that reflect the lower amount. If a higher debt to capital and free reserves ratio has been specified under the Companies Act, 2013, that ratio will take precedence[24].
- The ratio should be less than or equal to 2:1, based on either the standalone or consolidated financial statements of the company, whichever shows a lower amount, after excluding the financial statements of all subsidiaries that are non-banking financial companies and housing finance companies regulated by Reserve Bank of India or National Housing Bank, as applicable. However, the buy-back of securities is allowed only if all such excluded subsidiaries have a debt to paid-up capital and free reserves ratio of not more than 6:1 on a standalone basis[25].
- All shares or other designated securities to be repurchased must be fully paid-up. A company has the option to repurchase its shares or other specified securities using any of the following methods:
  i. from current shareholders or other specified securities holders on a proportional basis through a tender offer.
  ii. from the open market through
    - the book-building process,
    - the stock exchange.

24Pratheeka Varanasi, The Buyback Regulations in India (25 September 2024, 2:30 PM), https://www.legalserviceindia.com/legal/article-13141-the-buyback-regulations-in-india.html#google_vignette
25 Securities and Exchange Board of India, Securities and Exchange Board of India (Buy-Back of Securities) Regulations, 2018 [Last amended on 07 February 2023], (27 September 2024, 9:30AM), https://www.sebi.gov.in/legal/regulations/feb-2023/securities-and-exchange-board-of-india-buy-back-of-securities-regulations-2018-last-amended-on-07-february-2023-_69229.html

- If the buyback from the open market through stock exchanges is based on the company's standalone or consolidated financial statements, whichever sets out a lower amount, it can't exceed the following thresholds[26]:
    a. fifteen percent of the company's paid-up capital and free reserves through March 31, 2023.
    b. ten percent of the company's paid-up capital and free reserves through March 31, 2024.
    c. five percent of the company's paid-up capital and free reserves until March 31, 2025
- A company is prohibited from repurchasing its shares or other specified securities to remove them from the stock exchange. The company is not allowed to repurchase its shares or other specified securities from any individual through negotiated transactions, whether on or off the stock exchange, or through spot transactions or any private arrangement. The company cannot make a buy-back offer within one year following the expiration of the buyback period of the previous offer, if any.
- A company is prohibited from conducting a buy-back of its shares without effecting a consequent reduction of its share capital. A company is permitted to engage in a buy-back of its own shares or other specified securities using its free reserves, the securities premium account, or the proceeds of the issue of any shares or other specified securities.

  However, such buy-back cannot be made using the proceeds of a previous issue of the same kind of shares or other specified securities[27].
- A company is not allowed to directly or indirectly buy back its own shares or specified securities in the following ways:
    a) through any of its subsidiary companies, including its own subsidiary companies.
    b) through any investment company or group of investment companies; or
    c) if the company has defaulted on the repayment of deposits accepted before or after the commencement of the Companies Act, interest payments on the deposits, redemption of debentures or preference shares, payment of dividends to any shareholder, or repayment of any term loan or interest payable to any financial institution or banking company. However, the buy-back is allowed if

26 Ibid
27 Ibid

the default is rectified and a period of three years has passed after the default ceased to exist.

- **Attention to All Publicly Listed Companies:** Upon passing the resolution, it is mandatory for listed companies to publicly announce the buyback within 2 working days.
- **Limit on Buyback Offer Size:** The maximum offer size cannot exceed 25% of the company's paid-up capital and free reserves, as stipulated in the Companies Act.
- **Timeframe:** The buyback process must be finalized within 6 months from the date of passing the resolution.
- **Creation of Escrow Account:** Companies must establish and maintain an escrow account to ensure the availability of funds for the buyback.
- **Price Increase:** The company's board of directors now has the option to adjust the maximum buyback price and reduce the number of securities to be repurchased without changing the overall size of the buyback. This flexibility can be exercised until one working day before the record date and can help generate participation in the buyback, especially if there is a significant gap between the board approval and the opening of the buyback[28].
- **Lender covenants:** Documentation related to the buyback must include disclosures about any consents obtained by companies from their lenders for the buyback[29].

## TAXATION IMPLICATIONS

Repurchasing the company's previously issued shares to reclaim ownership of the company's shares is a crucial aspect of the organization's financial strategy. In the past, companies would sidestep taxes since there was no tax on share buybacks. However, the tax law was revised to incorporate **Section 115QA**, which introduced a tax on share buybacks. This article encompasses everything you should be aware of regarding the taxation of buybacks of listed shares[30].

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28 Yash J. Ashar & Aditya Prasad, Simplifications and Eliminations: A Synopsis of the Amended Buyback Regulations (01 October 2024, 02:18 AM), https://corporate.cyrilamarchandblogs.com/2023/02/simplifications-and-eliminations-a-synopsis-of-the-amended-buyback-regulations/

29 Ibid

30 Admin, Income Tax on Buyback of Shares (28 September 2024, 12:30 AM), https://tax2win.in/guide/income-tax-share-buyback

When companies distributed dividends, they were required to pay Dividend Distribution Tax (DDT). However, in the case of share buybacks, the tax obligation shifted to the shareholders in the form of capital gains, and the company itself was not liable for any tax on the buyback. Due to the generally lower capital gains tax rates and the fact that not all shareholders earn income exceeding the basic exemption limit, companies, especially those that are not listed, began favouring share buybacks over dividend payouts to avoid taxes. Certain foreign companies exploited tax treaties to evade taxes on capital gains. They advised investee companies against paying dividends and instead encouraged them to buy back shares, leading to tax-free capital gains for the foreign entities. To counter tax avoidance, the government introduced section 115QA under the Income Tax Act in 2013 for unlisted companies. In July 2019, these regulations were extended to encompass share buybacks by listed companies as well[31].

The finance minister announced a complete overhaul of the buyback taxation system. Currently, companies are required to pay taxes on the difference between the repurchase price and the original issue price of the shares. This system was introduced in 2013 to align with the dividend distribution tax at that time. However, with the removal of the dividend distribution tax in the 2020 Finance Act and the shift to taxing dividends at the recipient's end, the government's objective now is to harmonize the tax on buyback with that on distributed dividends. To achieve this goal, the plan is to eliminate the taxation on buybacks carried out by companies in the 2024 budget[32].

Following the changes in Budget 2024, any company conducting a buyback post-October 1, 2024, will not be taxed. Instead, the shareholder who receives the buyback amount will be responsible for paying taxes on the entire sum, which will be treated as a deemed dividend under the new system[33].

## RECENT AMENDMENTS AND TRENDS

The recent revisions made in 2024 pertaining to share buybacks in India have brought about significant modifications, particularly in relation to taxation and regulatory updates by SEBI.

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31 Ibid

32 Ibid

33Sunainaa Chadha, share buyback tax regime to change from October 1: What this means for you (30 September 2024, 05:17 PM), https://www.business-standard.com/finance/personal-finance/share-buyback-tax-regime-to-change-from-october-1-what-this-means-for-you-124081400849_1.html

1. **Tax Changes:** In the 2024 Budget, buybacks were reclassified as dividends and shareholders now bear the tax liability instead of companies. In the past, buybacks by corporations were subject to Section 115QA taxation, with shareholders being excluded. To bring buybacks into line with regular dividends, shareholders will be taxed on the full amount of the buyback as deemed dividend income beginning on October 1, 2024[34].
2. **SEBI Amendments:** The Buy-Back of Securities Regulations will see a 2024 revision from SEBI with the goal of enhancing compliance and transparency. Most notably, it enables businesses to calculate the volume-weighted average market price for buybacks without accounting for the effects of large price fluctuations. This change will take effect in May 2024 and is meant to simplify the buyback procedure while lessening the effects of abrupt price swings.

The purpose of these adjustments is to improve regulatory clarity and harmonize buyback and dividend tax treatment. They also force businesses and investors to modify their plans in order to account for the additional tax and compliance requirements[35].

## NUANCED TO WAYS IN WHICH BUYBACK POTENTIALLY INFLUENCES ECONOMIC FACTORS

In nuanced ways, buybacks can have an impact on various economic factors, influencing corporate strategy, market dynamics, and investor behaviour.

1. **Corporate Financial Structure:**

Capital Allocation: By reducing the equity base, buybacks change a company's financial structure. When they believe their stock is undervalued or want to optimize capital allocation, companies may choose buybacks over dividends to return surplus cash to shareholders[36].

Debt-Equity Ratio: If buybacks are financed through debt, they can increase a company's debt-to-equity ratio. While this can potentially enhance returns on equity and boost financial

34 Bharat Vasani & Miloni Mau, Buy-back of shares: Will recent changes in the tax laws end the party? (04 October 2024, 11:09 AM), https://corporate.cyrilamarchandblogs.com/2024/08/buy-back-of-shares-will-recent-changes-in-the-tax-laws-end-the-party/

35 Ibid

36 Troy Segal, Reasons Companies Choose Stock Buybacks (09 October 2024, 6:49 PM) https://www.investopedia.com/ask/answers/042015/why-would-company-buyback-its-own-shares.asp

leverage, it also raises the company's financial risk if future earnings or cash flows fall short of expectations[37].

2. **Stock Price and Market Perception:**

Short-term Price Increase: Buybacks often lead to a temporary rise in stock prices as they decrease the number of shares outstanding, thereby increasing perceived value and earnings per share (EPS). However, if companies use buybacks solely to boost EPS without underlying financial health, it could result in overvaluation.

Market Sentiment: Buybacks can indicate management's confidence in a company's future, providing reassurance to investors. However, frequent or poorly timed buybacks may be viewed as a lack of viable growth opportunities, which could negatively impact long-term investor confidence.

3. **Liquidity and Market Dynamics:**

Reduced Liquidity: Large-scale buybacks can reduce market liquidity, especially in less liquid stocks. This could heighten price volatility and impact price discovery mechanisms, making the stock more susceptible to market shocks.

Impact on Institutional Investors: Institutional investors often favor dividends over buybacks due to income predictability. While buybacks can be beneficial for price appreciation, they may not offer the consistent cash flow needed by certain types of institutional portfolios (e.g., pension funds)[38].

**Conclusion**

Current buyback regulations aim to improve corporate flexibility and shareholder returns, but they may have different impacts on various shareholder groups. Small shareholders face both opportunities and risks with buybacks. They could benefit from stock price appreciation and higher earnings per share, but they also face disadvantages such as information imbalance, insider advantages, and short-term stock price manipulation that may not align with long-term value creation.

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37 Ibid

38 Ibid

Reforming the regulatory frameworks governing buybacks is necessary to create a more equitable environment for small shareholders. This can be achieved through increased transparency, stricter controls on insider trading during buybacks, and encouraging companies to prioritize long-term growth over short-term financial tactics, which would provide better protection for small investors. Although buybacks are valuable in corporate finance, regulations must adapt to ensure that their advantages are fairly distributed and that small shareholders are not placed at a disadvantage.