Share Buybacks
Agenda

• Stock repurchase alternatives and an overview
• Rule 10b-18 basics
• Accelerated share repurchases
• Securities law issues
• Accounting treatment
• Conclusion
# Repurchase Options – Overview

<table>
<thead>
<tr>
<th>Evolutionary</th>
<th>Transformational</th>
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<tbody>
<tr>
<td>Low Execution Risk</td>
<td>High Execution Risk</td>
</tr>
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</table>

## Open Market
- Continued stock support
- “At-market” repurchase
- Maximum flexibility
- Lowest cost
- Can be executed as a 10b5-1 program or opportunistically

## Prepaid/Accelerated Share Repurchase
- Optional upfront share count reduction
- “At-market” repurchase
- Potential tax efficiencies
- Strong signal
- Economic protection/discount available

## Tender Offer
- Speed of repurchase completion near current valuation
- Strongest signal
- Liquidity event for investors
- Rapid share count reduction

## Advantages
- • Continued stock support
- • “At-market” repurchase
- • Maximum flexibility
- • Lowest cost
- • Can be executed as a 10b5-1 program or opportunistically

## Disadvantages
- • Limited by daily volume
- • Exposed to market price over time
- • Share count reduction over time
- • Weaker signal
- • No guarantee of completion

## Mechanics
- • Issuer purchases shares in the open market over time
- • Can buy back stock during blackout period via 10b5-1 program
- • Bank sells the block to issuer upfront
- • Bank repurchases stock in the open market over time
- • True-up payment and/or additional shares delivered at completion of cover period
- • Issuer specifies a number of shares to be repurchased within a defined price range or at specific fixed price
- • Shareholders decide whether they would like to participate in the offer
- • Tender offer open for a minimum of 20 days

## Documentation
- • Short form appointment letter
- • No public documentation
- • Master confirmation
- • No public documentation
- • Schedule Tender Offer (Schedule TO) filed with SEC

## Applications
- • Desire to maintain flexibility including ability to stop
- • Minimum value of shares Issuer desires to purchase
- • Repurchase large block of stock in a short period of time
RULE 10B-18 BASICS
Rule 10b-18

- A non-exclusive safe harbor from liability under market manipulation rules
- Manner of purchase
  - Single day, single broker/dealer
- Timing condition
  - Limits periods during which an issuer may bid for or buy its common stock
  - Purchase by the issuer cannot be the opening transaction reported on the consolidated quotation system
  - Where the purchase is effected for a security that has an ADTV of $1 million or more and a public float of $150 million or more, the purchase cannot be effected during the 10 minutes before the scheduled close of the primary trading session in the principal market for the security, and the last 10 minutes before the scheduled closed of the primary trading session in the market where the purchase is effected
Rule 10b-18, cont’d

- For all other securities, purchases cannot be effected during the 30 minutes before the scheduled close of the primary trading session in the principal market for the security and the 30 minutes before the scheduled close of the primary trading session in the market where the purchase is effected.

- Under certain conditions, an issuer purchase can be effected following the close of the primary trading session in the principal market until the termination of the period in which the last sales prices are reported in the consolidated system.

• Price condition: repurchases must be made at a price not exceeding the highest independent bid or last transaction price, whichever is higher, if during trading hours the security is: reported on the CQS, displayed and disseminated on any national securities exchange or quoted on any interdealer quotation system that displays at least two price quotes.
Rule 10b-18, cont’d

• Volume condition: the purchases must satisfy certain volume limits – usually purchases on a single day cannot exceed 25% of the ADTV in the preceding four weeks

• The non-exclusive safe harbor is available for common stock (or the equivalent) but not for preferred stock, warrants, convertible debt, etc.

• Purchases by an affiliated purchaser may under certain circumstances be attributable to the issuer under Rule 10b-18

• The company should assess whether it has material nonpublic information
  – Availability of Rule 10b5-1
  – Insider purchases and sales
State Law Considerations

- For a Delaware corporation, Section 160 of the DGCL allows a company to purchase or redeem its shares from stockholders so long as its capital is not and would not become impaired.
- The board’s determination of “surplus” should be sufficient.
- The board also should consider whether the repurchase would cause the company to become insolvent.
Rule 10b-18 Program Documentation

• Selecting a broker
  – Documenting the repurchase plan
• Trading windows or reliance on Rule 10b5-1
• Designee(s) to monitor repurchases
• Notifications to insiders and compliance procedures
• Press release and Form 8-K filing
• Periodic filings containing reports of repurchases
• Monitoring other ongoing or proposed corporate transactions
ACCELERATED SHARE REPURCHASES
What Is an ASR?

• An accelerated share repurchase, or ASR, is a structured, privately negotiated transaction, usually documented as a “forward” contract, in which a dealer agrees to sell a pre-defined amount of stock to a company at a price per share that is based on the VWAP during the relevant period.

• A dealer acts as the “seller” of company shares in an ASR, and the company acts as the “purchaser” in buying back its own shares.

• Numerous dealers have engaged in ASRs with their corporate clients.

• Although ASRs are now commoditized to a significant extent, they do entail legal considerations that require review by counsel.
Rationale for ASRs

• Efficiency
  – Permits buybacks at less than the VWAP

• Immediacy
  – Immediate share count reduction

• Certainty
  – Timing and quantity of buyback are known upfront

• Signal to market
  – Strong signal through commitment (often announced in press release) to repurchase shares

• Possible accounting advantages
  – Immediate EPS benefit and “equity treatment” for transaction, so mark-to-market may not hit income statement
Rationale for ASRs, *cont’d*

- However, ASRs have been criticized for:
  - Potential liability concerns
  - Unusual pre-transaction stock activity in certain cases
  - Lack of full and accurate disclosures
  - Inferior risk/reward compared with alternatives, including simple Rule 10b-18 programs
How Does an ASR Work?

• At the beginning of the ASR:
  – The company pays a pre-defined dollar amount to the dealer
  – The dealer borrows stock from current holders of the equity (stock lenders)
  – The dealer delivers these shares to the company (typically 80% of the underlying shares)

• Over time:
  – The dealer buys stock in the market to cover the shares it borrowed
  – The dealer typically has the option to complete the ASR at any time during a pre-agreed period
  – This option and its associated option value generates a discounted repurchase price for the company
How Does an ASR Work?, *cont’d*

- At final settlement:
  - The total number of shares purchased by the company equals the ASR dollar size divided by the discounted average price.
  - If the dealer did not deliver enough stock upfront, it delivers incremental shares to the company at the end of the ASR.
  - If the dealer delivered too many shares, the company will owe the dealer (and can typically settle in cash or in shares).
Initial purchase: Issuer buys a block of shares from the dealer
ASR – During Trade

- Dealer borrows shares from stock lenders to deliver to issuer on trade date
- Dealer shorts the total number of shares to be repurchased
• Over the life of the trade, dealer covers short by purchasing shares of the issuer in the open market

• Purchase period will have a fixed starting and end point, though dealer will have right, upon notice to issuer, to cut short the purchase period

• An average price (A) will be determined for the purchase period
  – Typically will be based on 10b-18 VWAP for every trading day during the purchase period, minus an agreed discount or price adjustment
At settlement (cash/physical):

- If average (A) differs from initial price (B), a settlement at maturity will be due from one party to the other
- The amount of the settlement due will be based on the difference between the aggregate purchase price based on A and the aggregate purchase price based on B
ASR at Maturity, *cont’d*

- If average price (A) is below the initial price (B), then the dealer will owe the final settlement to the issuer:
  - In general, ASRs will provide that the dealer will make physical settlement by delivering extra shares to the issuer:
  - The number of extra shares will equal:
    - The amount the issuer paid at trade inception divided by A minus the number of shares the dealer sold to the issuer at trade inception

- If the average price (A) is above the initial price (B), issuer will owe the final settlement to the dealer
  - The issuer will have the election to make settlement either in cash or by delivery of additional shares
  - However, when settlement is due from the issuer, more complex settlement mechanisms are triggered to address various securities law issues raised by the prospect of an issuer issuing shares
Structured Alternatives in ASRs

• Alternatives to vanilla “VWAP minus” structure?
  – Large majority of ASRs are now based on straightforward VWAP minus structure
  – However, it is possible to set a maximum and minimum (a collared structure) or, alternatively, either a maximum or minimum, on the number of shares to be repurchased
  – Can also structure for
    • Fixed dollar or fixed shares;
    • Upfront or delayed share delivery; and
    • Knock-out days or other bespoke features
  – Structural complexities may raise additional securities law concerns, especially during a hedging period when collar levels are being established
Collared ASR

- In many respects similar to a basic ASR:
  - Issuer executes an accelerated share repurchase program to repurchase shares at a discount to the average 10b-18 VWAP over the term
  - Issuer spends a fixed dollar amount to repurchase stock
    - Total number of shares repurchased equals:
      - Upfront payment divided by [Average Daily 10b-18 VWAP-discount], subject to a minimum and maximum number of shares
      - Total repurchase cost fixed upfront
      - Shares repurchased at a discount to average daily 10b-18 VWAP
- However, collar protects issuer if stock price appreciates and allows issuer to participate in price depreciation up to the minimum repurchase price
Collared Forward Share Repurchase

• Issuer pays a fixed aggregate purchase price
• Dealer delivers a variable number of shares determined on a per-share purchase price equal to the average price that is subject to a collar
  – Cap on average price equals strike price of a call option purchased by the issuer on its own stock
  – Floor on average price represents strike price of a put option purchased by the dealer on the stock
• Permits issuer to retire the minimum number of shares at inception of trade (boosts EPS)
• Lets issuer repurchase shares at average price over term, minimizing volatility
Collared Forward – At Inception

Issuer → Dealer
aggregate purchase price

Minimum number of shares

Dealer → Market
initial hedge

Market → Lender
shares

Cash

Lender → Dealer

Collared Forward Share Repurchase, *cont’d*

- Parties agree aggregate price, floor on per-share price and cap on per-share price
- Issuer pays aggregate price
- Dealer establishes initial hedge for collar by buying shares over a period of days
- After initial hedge period, dealer delivers minimum number of shares (divide cap price per share into aggregate purchase price)
- At maturity, total number of shares to be purchased is determined by dividing average price over term of trade into aggregate price
- If total number of shares is greater than the minimum number delivered initially, dealer delivers additional shares (but never more than the maximum)
Documentation

• Documentation for ASRs has not become fully standardized
• Two basic structures
  – Master confirmation (an in some instances, master agreement solely for ASR transactions) with supplemental confirmations containing economic terms for individual transactions
  – Stand-alone long-form confirmations incorporating or referencing an ISDA Master Agreement
• The master confirmation structure is more prevalent than the stand alone form confirmation structure
  – Master confirmation is efficient way to execute multiple transactions with the same legal terms
• Master confirmations typically incorporate the form of ISDA Master Agreement, but they may or may not incorporate, and be based on the terminology contained in, the ISDA Equity Derivatives Definitions
• Stand-alone confirmations are generally ISDA-based
• Securities law issues are addressed in a similar manner in either case
Practicalities of Execution

• A company typically pre-negotiates forms of ASR documents with members of its lending syndicate
  – Can be challenging for non-syndicate members to compete for deals
• Execution usually occurs during a window period, when companies are free to trade in their shares
• Companies typically drive to execute with compressed time frame
  – Companies often give short notice, providing information as to the size of a proposed transaction and requesting quotes from a trading desk for a transaction based on the pre-negotiated documentation
  – Initial settlement is typically quick, and can even be same-day, on date of execution
• Practices differ with respect to public filing of ASR documents
  – Some companies file ASR documents with the SEC based on their assessment that the ASR represents a “material contract”
SECURITIES LAW ISSUES
Legal Considerations – Section 5

• The possibility that an ASR may be deemed to constitute an issuance of shares by an issuer is a concern under Section 5 of the 1933 Act, which prohibits the offer or sale of any security in the absence of an effective registration statement.

• Section 5 concerns may arise as a result of trading or hedging activity by the dealer or shares issued by the dealer in net settlement.
  – Attribution issues:
    • Can dealer’s market purchases be attributed back to the issuer and require that the dealer’s short covering be subject to Section 5 registration requirements?
    • Can dealer’s hedging be attributed to the issuer?
    • Addressed by de-linking transactions so that the issuer doesn’t share in dealer’s losses or benefit from dealer’s gains from hedging.
Legal Considerations – Section 5, cont’d

• An issuer can demonstrate, particularly by means of VWAP-based pricing, that the economic consequences of the dealer’s share purchases and sales are not attributable to the company, thus minimizing any claim that the company must comply with Section 5 of the 1933 Act

• Economics of dealer’s trading activity during averaging period does not flow directly back to issuer, even if dealer sells shares on a given day

• Additional concerns if issuer needs to net share settle at end of trade
  – If issuer is required to deliver shares, that would implicate Section 5 of the 1933 Act
  – Registration or exemption would be required for net settlement shares from issuer
Section 9 and Section 10 of the Exchange Act

- Section 9(a)(2) — cannot effect any transaction or series of transactions in any security that creates actual or apparent active trading in that security, or raises or depresses its price, for the purpose of inducing the purchase or sale of the security.

- Section 10(b) — cannot employ any manipulative or deceptive device or contrivance in connection with the purchase or sale of a security.

- Rule 10b-5 — cannot employ any device, scheme or artifice to defraud, make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made not misleading, or engage in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.
Section 9 and Section 10 of the Exchange Act, cont’d

– The potential for 10b-5 liability can be minimized by structuring the ASR as a Rule 10b5-1 trading plan and conforming the ASR to Rule 10b5-1’s requirements, thus enabling the assertion of defenses to 10b-5 claims

– This means that the company will not have any influence over how, when or whether the dealer will effect purchases of stock in connection with the ASR
10b-18 Safe Harbor

- Rule 10b-18 provides a company with a non-exclusive safe harbor from liability under certain market manipulation rules (i.e., Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act) when repurchases of the company’s common stock in the market are made in accordance with the rule’s manner, timing, price and volume conditions.

- Though 10b-18 does not directly apply to derivatives transactions, most market participants nonetheless rely on 10b-18 by analogy.

- SEC Division of Market Regulation: Answers to Frequently Asked Questions Concerning Rule 10b-18 (as modified, November 17, 2004)
  - Question 13: Is the Rule 10b-18 safe harbor available for an issuer and the broker-dealer who engage in an accelerated share repurchase plan or use a forward contract to repurchase the issuer’s stock?
10b-18 Safe Harbor, cont’d

• Answer: Accelerated share repurchase plans and forward contracts are private (off-market) transactions. Therefore, they are not eligible for the Rule 10b-18 safe harbor, which applies only to open market purchases. Moreover, the Rule 10b-18 safe harbor also is not available for the broker’s covering transactions, as these transactions are not agency or riskless principal trades effected on behalf of the issuer.

• The conditions of 10b-18 include:
  – A single broker or dealer making purchases/sales on a single day
  – Trading window
  – Price restrictions
  – Volume thresholds
Legal Considerations – Rule 10b-18

• Despite the safe harbor not being available, an ASR typically provides that the dealer will implement the repurchase program according to the company’s instructions and in accordance with the requirements of Rule 10b-18

• This is particularly applicable during a period when a dealer is engaging in more than ordinary daily buy-in activity, such as
  – When establishing its initial delta hedge for a collared transaction, or
  – Buying-in additional settlement shares after the averaging period is over

• This supports the view that the activities related to the transaction should not raise manipulation concerns under the 1934 Act

• Agreements may incorporate Rule 10b-18 provisions in setting out the mechanics of the transaction, including with respect to mechanics of the buy-in of the stock and the pricing of the stock to be sold by the dealer to the company
Rule 10b5-1

• 10b5-1 establishes an affirmative defense to claims that a person has made a purchase or sale on the basis of material nonpublic information
• An issuer also may rely on 10b5-1 for itself
  – Issuer should represent that it is not in possession of material nonpublic information when entering into the ASR/CASR
  – ASR/CASR will not permit the issuer to influence the bank’s purchases or to share material nonpublic information with the dealer
  – Issuer will not be able to change terms, except when it can represent that it is not in possession of MNPI
  – Program may establish black-outs (most arrangements then extend the term of the ASR/CASR for each black-out day
• If a transaction gives an issuer any option (such as whether to make cash or physical settlement), the issuer may be required to repeat its representation that it does not possess MNPI if it makes such election
Regulation M

- Reg M prohibits the issuer, affiliated purchasers and distribution participants from bidding for, purchasing or attempting to induce any person to bid for or purchase securities that are the subject of a distribution or reference securities.

- Regulation M, subject to certain exceptions, prohibits such parties from bidding for, purchasing or attempting to induce any person to bid for or purchase a security that is the subject of a “distribution.”

- The definition of “distribution” is complex.

- ASRs typically include provisions to the effect that the company is not engaged in any “distribution” that would cause the dealer to violate any law, and at relevant times will not make any “distribution.”

  - Company’s reps and covenants generally place the burden on the Company to not engage in any distributions that would cause a restriction under Reg M to arise during the term of the ASR.
Share Repurchase Windows in Context of Stock Acquisition

- Reg M prohibits share repurchases during any averaging period where the amount of acquirer stock to be issued to the target company shareholders is determined.

- The Rule 10b-18 volume limit is reduced to the actual amount of share repurchases per day for the prior 3 calendar months upon the announcement of an acquisition involving issuance of acquirer stock to target company shareholders.

- The Rule 10b-18 volume limit returns to normal upon the closing of the acquisition.

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**Today**

- General agreement on acquisition terms and valuation

**Materiality Threshold?**

- Legal, financial and accounting due diligence
- Negotiable merger agreement

**Sign Definitive Agreement/Announce Transaction**

- HSR and other regulatory approvals
- Potential outs:
  - Higher offer/fiduciary out
  - Material adverse effect
  - Failure to obtain antitrust clearance

**Regulatory Approvals**

- Rule 10b-18 volume reduces to actual amount of repurchase per day over prior 3 calendar months
- Likely unable to repurchase stock through this entire time period except under Rule 10b5-1 plan given disclosure issues

**Averaging Period Starts (if any)**

- Repurchases prohibited by Reg M

**Close Transaction**
Disclosure

• Exchange will require disclosure — disclosure may be made as to repurchase authorization generally

• Issuer may file an Item 7.01 Form 8-K

• Issuer will be required to disclose repurchases in its Exchange Act filings
Short Sales

• Section 10(a)(1), 10(b)(21) and Reg SHO would be applicable to short sales by dealer
• Section 10(a)(1) provides that it shall be unlawful for any person directly or indirectly to effect a short sale in contravention of rules and regulations
• Reg SHO requires that: (1) broker-dealer must borrow the shares or have reasonable grounds to believe that the shares can be borrowed in time for delivery on the settlement date of the short sale prior to accepting a short sale order or executing a short sale, and (2) the failure to deliver certain shares due on the settlement date must be cured by purchasing and delivering shares of like kind and quantity within the time specified by Reg SHO
Corporate Issues

• Board authorization for repurchases and specifically for the ASR/CASR
  – Resolutions should be specific
  – Issuer should understand all of the alternatives
  – State law requirements as to adequate capital and surplus for a repurchase
  – Issuer should consult accountants

• Issuer should ensure no conflicts with credit agreements (or other agreements)
  – Timing considerations: related to earnings, acquisitions, etc.
Regulatory Treatment

• ASRs are not treated as swaps or as security-based swaps but, instead, as security forwards

• They are generally understood to fall into Dodd-Frank Act exclusions from the definition of “swap” (and “security-based swap”)

• The CFTC and SEC stated in their joint release further defining (among other things) the terms “swap”:
  – “The Dodd-Frank Act excludes purchases and sales of securities from the swap and security-based swap definitions in a number of different clauses. Under these exclusions, purchases and sales of securities on a fixed or contingent basis and sales of securities for deferred shipment or delivery that are intended to be physically delivered are explicitly excluded from the swap and security-based swap definitions ... As with other purchases and sales of securities, security forwards are excluded from the swap and security-based swap definitions.”
Accounting Treatment
Accounting Treatment

• Generally, an ASR is accounted for as two separate transactions from an accounting perspective
  – Record the purchase of treasury stock;
  – Account for a forward sale contract (derivative), which is treated as an equity instrument
    • Derivative on the issuer’s own stock
    • Issuer has the option to settle by issuing shares
      – Under GAAP (now), issuer is not required to mark to market
  – Amount paid/received at settlement is recorded as an adjustment to stockholders’ equity (no income effect)
• Gains/losses from transactions that can be settled in either cash/stock are not reflected in earnings
• Intended settlement (cash/stock) will dictate computation of EPS
The following is an example of the accounting treatment for an ASR. Suppose Company X wants to buy back 1 million shares of stock. Currently, the company has 10 million shares outstanding and the stock price is $10 per share. After the decision, the company has net earnings of $2 million for the quarter ended March 31.

Scenario 1: The stock price stays the same over the quarter. Company X enters into an ASR agreement on January 1 and agrees to repurchase 1 million shares of stock. The ASR has an end contract date of March 31. The current stock price is $10 per share.

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<th>Jan. 1:</th>
<th>Treasury Stock</th>
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<tr>
<td></td>
<td>Cash or Liability</td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>
Accounting Treatment, *cont’d*

- Forward agreement: no entry made as the forward contract has no significant value at the contract’s initiation date.

**April 30: No entries required**

**Effect on EPS at 4/30:**

With ASR: 
$\frac{2,000,000}{9,000,000} = .22$

Without ASR: 
$\frac{2,000,000}{10,000,000} = .20$
Accounting Treatment, *cont’d*

- Scenario 2: The stock price increases to $15/share on January 31 and remains there for the rest of the quarter.

  Jan 1:
  
<table>
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<th>Description</th>
<th>Amount</th>
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<tr>
<td>Treasury Stock</td>
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</tr>
<tr>
<td>Cash or Liability</td>
<td>$10,000,000</td>
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</tbody>
</table>

  April 30:
  
  If settled in cash:
  
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury Stock</td>
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</tr>
<tr>
<td>Cash or Liability</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>

  If settled in stock:
  
  An adjustment would be made to the shares outstanding. The company would now show that approximately 666,667 shares have been repurchased, versus 1,000,000. There is no impact on the balance sheet.
CONCLUSION
Conclusion

• Repurchase alternatives are very flexible and Rule 10b-18 functions only as a safe harbor

• An issuer should consider carefully its objectives before choosing an approach and should consider how any repurchase will function amid other corporate events

• Following the tax reforms, stock repurchases have triggered controversy and there have been calls to rescind Rule 10b-18, review the rule, and address insider transactions in proximity to announced repurchases
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