THE CLS BLUE SKY BLOG

COLUMBIA LAW SCHOOL'S BLOG ON CORPORATIONS AND THE CAPITAL MARKETS

Skadden on Revisiting Share Repurchases in Volatile Times

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Comment

In light of the recent increased volatility in the global financial markets,[1] a number of companies have raised questions regarding the desirability of repurchasing shares at reduced market prices. This alert addresses questions surrounding share repurchases that companies should consider as they evaluate the advantages, disadvantages, legal implications and strategic considerations of share repurchases in a turbulent market.

Overview

As a preliminary matter, any company contemplating a share repurchase should consider the limitations set forth within the Coronavirus Aid, Relief, and Economic Security Act, passed into law on March 27, 2020; the Consolidated Appropriations Act, 2021, passed into law on December 27, 2020; and the American Rescue Plan Act of 2021, passed into law on March 11, 2021 (collectively, Acts). Among other restrictions, if a company procures a loan or received financial assistance under such Acts, that company and its affiliates may be prohibited from buying back the company's public stock (unless contractually obligated to do so prior to the enactment of the CARES Act) until one year after the loan is repaid, the financial assistance received is expended, or September 30, 2022, whichever applicable date is the latest.

Moreover, the Securities and Exchange Commission (SEC) reiterated in light of the COVID-19 crisis the importance of maintaining market integrity and adhering to corporate controls and procedures, particularly with respect to material nonpublic information (MNPI) and insider trading. On March 23, 2020, the co-directors of the SEC's Division of Enforcement remarked that corporate insiders "are regularly learning new material nonpublic information that may hold an even greater value than under normal circumstances," especially given potential delays in disclosure filings and earnings releases. Given the rapidly evolving geopolitical situation and the breadth of potential market impacts, corporate insiders may again have access to valuable MNPI. Recent SEC enforcement trends suggest renewed focus on insider trading, while share repurchases have also been subjected to increased media and political scrutiny and future legislation could have the effect of disincentivizing share repurchases by issuers. Corporate insiders should be especially mindful of their market activities and their obligations to keep MNPI confidential and to refrain from illegal securities trading.Beginning December 15, 2021, the SEC proposed a slate of new rules and disclosure requirements intended to address what it perceives as potentially abusive practices engaged in by public companies, directors and officers relating to Rule 10b5-1 trading plans. Among other things, the amendments are intended to reduce the potential for opportunistic and harmful use of repurchases by company insiders who may seek to exploit informational asymmetries between themselves and investors. Current proposals include:

(i) imposing a mandatory "cooling-off" period of 120 days for officers and directors, and 30 days generally, between when a plan is adopted or modified and when trading can commence;

(ii) requiring directors and officers to personally certify to the company that they are not in possession of material nonpublic information at the time of adoption or modification of a plan;

(iii) providing that the affirmative defense under Rule 10b5-1(c)(1) does not apply to multiple overlapping Rule 10b5-1 trading arrangements in the same class of securities;

(iv) limiting the availability of the affirmative defense under Rule 10b5-1(c)(1) for a single-trade plan to one single-trade plan during any consecutive 12-month period; and

(v) expanding the current good faith requirement that parties not only enter into Rule 10b5-1 plans in good faith but also operate the plans in good faith.[2]

If adopted, such rules would significantly impact many of the common practices that companies and their insiders have come to rely on to manage equity award programs and to conduct share repurchases and personal trading. Additionally, the proposed rules would impose increased reporting and disclosure requirements on both issuers and company insiders.[3] We expect the SEC to focus on adopting final rules shortly after the conclusion of the comment period on April 1, 2022, so issuers that are considering establishing new trading plans should consider the likelihood that upcoming new plans will need to comply with the proposed rules.

What are the ways a company can repurchase its shares?

A company can repurchase its shares in four principal ways, all of which are discussed below:

1. open market purchases;
2. issuer tender offers;
3. privately negotiated repurchases; and
4. structured programs, including accelerated share repurchase programs.

Most share repurchases are effected over time through open market purchases. These are often referred to as share repurchase programs or plans.

Why should a company repurchase its shares?

A company might consider repurchasing its shares for a number of reasons, including to:

- return capital to shareholders in a more tax-efficient manner than declaring dividends;
- signal to the market that its shares are undervalued and thus a good investment, particularly due to current volatility;
- offset the dilutive impact of merger and acquisition activity and exercises of employee stock options; and
- reduce outstanding share count, thereby increasing earnings per share or improving other metrics based on the number of outstanding shares.

A company contemplating a share repurchase should, after consultation with outside counsel and other advisers, ensure that it has the authority to repurchase its shares and confirm whether it is subject to any limitations or restrictions on repurchasing shares. Companies should review:

- relevant law of its state of incorporation, including laws setting forth capital or surplus requirements to repurchase shares. For example, Section 160 of the Delaware General Corporation Law prohibits a corporation from purchasing its shares of capital stock when the purchase "would cause any impairment of the capital of the corporation";[4]
- its organizational documents, including its certificate of incorporation and bylaws;
- any agreements that may restrict or limit its ability to repurchase its securities. In particular, credit agreements, indentures, shareholder agreements, call spread transactions and other similar documents and transactions should be reviewed carefully (for example, such agreements may include a restricted payments covenant that limits the repurchase of common shares);[5]
- any applicable requirements imposed by any stock exchange on which its shares are listed;[6] and
- tax and accounting treatment of share repurchases.

In addition, a company may not initiate a share repurchase (or establish a plan under Rule 10b5-1 to do so in the future, as described below) at a time when the company possesses material nonpublic information.

Should a company's board of directors explicitly approve the repurchase before it is implemented?

Yes. Any share repurchase should be authorized and approved by a company's board of directors. Among the factors that the board should consider are the impact of the repurchase on the cash position of the company, the capital needs of the company and whether there is a better alternative use of the company's cash surplus, such as acquisitions or capital expenditures. The board should discuss and document the goal of the repurchase. By doing so, the board can demonstrate that it properly considered its shareholders' best interests and that it properly discharged its fiduciary duties. Furthermore, the board must consider the alignment of a repurchase with state laws, the company's constituent documents and agreements, stock exchange rules and tax and accounting treatment. For example, under Delaware law and the law of other states, directors may have personal liability for an unlawful share repurchase.

Should a company publicly disclose its share repurchase program?

Yes. In order to avoid potential liability for insider trading in connection with a share repurchase program, a company should publicly disclose the program prior to its commencement. Because the extent of the required public disclosure depends on the facts specific to the share repurchase program, a company should disclose the program after consultation with counsel. At a minimum, disclosure should include the following information and be made with enough time to allow the market to absorb the announcement:

- the estimated time period during which the purchases will be made;
- the maximum number of shares proposed to be acquired or the maximum amount of funds to be expended;

- the objective of the acquisition of shares;
- any plan or proposal relating to the disposition of the shares to be purchased; and
- an indication of how the purchases will be made.

A company can disclose this information in a Form 10-Q or 10-K or by means of a press release or Form 8-K, depending upon the timing of the approval and commencement of the program. The company should also issue a public announcement disclosing any material modifications to a share repurchase program (and should announce any increase in the size of a program).

Is a company subject to any reporting requirements in connection with its repurchase program?

Yes. Item 703 of Regulation S-K requires that, for all issuer repurchases of equity securities (whether an open market or private transaction), the company must disclose in its next periodic report the following information, in tabular form, for each month of the preceding fiscal quarter:[7]

- the total number of shares purchased;
- the average price paid per share;
- the number of shares purchased as part of a publicly announced program; and
- the maximum number of shares (or approximate dollar value) that may yet be repurchased under the program.

Additionally, for publicly announced programs, the SEC requires disclosure (in footnotes to the table) of the following information:

- the date of the announcement;
- the share or dollar amount approved by the board of directors;
- the expiration date (if any) of the program;
- each program that has expired during the last fiscal quarter; and
- each program that the issuer has determined to terminate prior to expiration or under which the issuer does not intend to make further purchases.

Companies generally also include disclosure in the liquidity and capital resource section of their "Management's Discussion and Analysis of Financial Condition and Results of Operations" in their annual and quarterly reports.

How should a company consider earnings guidance preceding the company's implementation of a share repurchase program?

As in the ordinary course of business, a company contemplating a share repurchase should examine its past earnings guidance to ensure that subsequent developments have not rendered such guidance materially misleading. Companies should pay close attention to earnings guidance given in the midst of a turbulent market and uncertain economic conditions because such guidance is more likely to be revealed, in hindsight, to have been based on faulty assumptions. Overly pessimistic guidance runs the risk of inducing investors to participate in a share repurchase where they otherwise would have abstained, particularly where more accurate projections would have pointed to stronger future earnings.To minimize the risk of potential liability under Rule 10b-5 in the current market environment, a company contemplating a share repurchase should be wary of allowing too much time to elapse between releasing its earnings guidance and implementing a share repurchase program. Initiating a contemplated share repurchase close to the time earnings guidance is released reduces the likelihood of subsequent developments retroactively rendering such guidance materially misleading. If developments arise that cause a company's prior earnings guidance to be misleading, the company should consult counsel and update such guidance before proceeding with its share repurchase.

Open Market Share Repurchase Programs

Avoiding fraudulent and manipulative practices

What legal issues should a company be aware of as it designs and implements its repurchase program?

Sections 9(a) and 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) prohibit fraudulent and manipulative practices in connection with an issuer's or "affiliated purchaser's"[8] purchase and sale of the issuer's securities.

Rule 10b-18 provides a nonexclusive safe harbor against allegations of market manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5 under the Exchange Act solely by reason of the manner, timing, price and volume of the repurchases when the company's repurchases are made in accordance with the conditions set forth in the rule. Rule 10b-18, however, does not protect against other types of violations of the Exchange Act and Rule 10b-5, such as violations arising from purchases made by an issuer on the basis of material nonpublic information.

In order to fall under Rule 10b-18's safe harbor, a company and its affiliated purchasers, taken together, must meet all the following conditions:

(i) **Manner:** All of the bids and purchases must be made through only one broker or dealer on any single day.[9]

(ii) **Timing:** The purchases must not:

(a) constitute the opening transaction;

(b) for a security that during the preceding four weeks has an average daily trading volume (ADTV) value[10] of at least $1 million and a public float value of at least $150 million: be made during the 10 minutes before the scheduled close of the primary trading session in the security's principal market or during the 10 minutes before the scheduled close of the primary trading session in the market where the purchase is made; and

(c) for all other securities: be made during the 30 minutes before the scheduled close of the primary trading session in the security's principal market or the 30 minutes before the scheduled close of the primary trading session in the market where the purchase is made.[11]

(iii) **Volume:** The aggregate purchases on any given day must not exceed 25% of the purchased security's ADTV. "Block" trades[12] typically will be included in computing a security's ADTV. However, once per week, "in lieu of purchasing under the 25 percent of ADTV limit for that day,"[13] a company or its affiliated purchasers may make one block trade of its shares without regard to the volume limit, provided that it does not make any other Rule 10b-18 purchases on the same day. Purchases made pursuant to this block trade exception will not be included in computing a security's ADTV for purposes of Rule 10b-18 volume limits.

(iv) **Price:** The purchases must not be made at a price that exceeds the highest independent bid or the last independent transaction price (whichever is higher) quoted or reported in the consolidated system at the time the purchase is made.[14]

The safe harbor applies on a daily basis, and a failure to meet any one of the four conditions will remove all of a company's repurchases from the safe harbor for the day.

Generally, companies attempt to comply with Rule 10b-18, including in their 10b-5 plans. Companies typically enter into an arrangement with a broker or dealer that agrees to implement the repurchase program according to the companies' instructions and in accordance with the requirements of Rule 10b-18. All of the major brokerage firms understand the Rule 10b-18 requirements and implement programs accordingly.

What types of purchases are not protected by Rule 10b-18?

In some instances, a company will not be able to avail itself of Rule 10b-18's safe harbor protection. Repurchases that are made as part of a plan or scheme to evade the federal securities laws, even if made in technical compliance with the rule, are not protected. In addition, the safe harbor does not apply to certain types of repurchases, including: (i) purchases made in a tender offer; (ii) purchases effected by or for an employee plan by an agent independent of the issuer; (iii) purchases of fractional security interests; or (iv) certain purchases during the period starting at the public announcement of a merger, acquisition or similar transaction involving a recapitalization and ending at the earlier of the completion of such transaction or the vote by target shareholders.[15] The safe harbor also does not apply to the repurchase of any security other than common stock (or an equivalent interest) or purchases made outside the United States.

Should a company designing its repurchase program in accordance with Rule 10b-18 monitor the activities of its affiliated purchasers?

Yes. For purposes of the single broker and volume requirements, the activities of affiliated purchasers will be aggregated with those of the company. Therefore a company should be aware of its affiliated purchasers' activities. Affiliated purchasers may include directors and officers of the company, significant shareholders or entities affiliated with significant shareholders.[16] However, the definition of "affiliated purchaser" is nuanced, and a company designing a repurchase program should consult with counsel to identify any potential affiliated purchasers.

Insider Trading

Even if a repurchase is made in accordance with Rule 10b-18, a company is not protected against other types of violations of the Exchange Act, such as violations arising from purchases made by the company while in possession of material nonpublic information.

What steps can a company take in order to avoid liability for insider trading?

A company's position as the ultimate insider magnifies concerns about it purchasing shares while in possession of material nonpublic information. If any director, officer or employee of the company is in possession of material, nonpublic information about the company, the company should not be repurchasing shares. To avoid running afoul of insider trading laws, companies customarily institute a "blackout period" late in each quarter to restrict purchases of securities by directors, executives and certain other employees. Blackout periods can vary, so a company should consult counsel regarding an appropriate length for its blackout period given its individual circumstances.

If the company does not possess material nonpublic information, one step that the company can take in order to protect itself with respect to repurchases in the future is to implement a Rule 10b5-1 trading plan. If the company is repurchasing outside of a Rule 10b5-1 trading plan, it should limit its purchases to periods when officers and directors are able to buy and sell securities of the company. In addition, the company can choose to disclose any material nonpublic information prior to any share repurchase if the company possesses material nonpublic information at a time when it is seeking to make a share repurchase outside of a Rule 10b5-1 trading plan.

What is a Rule 10b5-1 trading plan?

A company engaged in a share repurchase program can establish a trading plan pursuant to Rule 10b5-1 in order to provide instructions to a broker to effect repurchases at a later date. This plan can be used to establish an affirmative defense to a claim that a company was aware of material nonpublic information when any such repurchases are then effected.

A trading plan must meet the following conditions to comply with Rule 10b5-1:

- **Trading must be preestablished.** The binding contract, trading instruction or written plan must be established at a time when the company is not in possession of material nonpublic information (and is usually established in a company's "window period").[17]
- **The plan must set trading criteria.** The binding contract, trading instruction or written plan either sets (or sets a formula for) the amount, price and date of purchases (a Rule 10b5-1 plan typically is not adopted in connection with a single purchase) or delegates those decisions to a broker or dealer.
- **No subsequent discretion is permitted as to the amount, price or dates of trades.** The binding contract, trading instruction or written plan does not allow the company to have further influence over how, when or whether to effect purchases. The company does, however, retain the discretion to terminate a Rule 10b5-1 plan.
- **The company must establish the plan in good faith.** The company must enter into the plan, and give all instructions thereunder, in good faith and not to evade the prohibitions of Rule 10b-5.
- **Only purchases pursuant to trading plan are permitted.** Purchases may only occur pursuant to the trading plan such that the company does not alter or deviate from the trading plan or enter into or alter a corresponding or hedging transaction with respect to the securities.

The advantage of a Rule 10b5-1 plan is that it allows a company to continue repurchasing its shares in the open market while in possession of material nonpublic information. The disadvantage of such a plan is that a company may lose discretion over its repurchases and will be at risk to market changes that may render the plan undesirable. A company can minimize the risks of an "autopilot" plan by limiting the duration, number of shares or amount of money subject to the plan and by taking advantage of the company's ability to set specified formulas for repurchases that vary depending upon market performance or other factors. In addition, implementing "side-by-side" programs may be possible whereby a Rule 10b5-1 plan operates alongside a discretionary plan, allowing the company to take advantage of the ability to purchase during blackout periods provided by Rule 10b5-1 without giving up discretion over purchases during open window periods under the discretionary plan.

Many companies elect to disclose the existence of such plans or their intentions to enter into such a plan to effect some or all of an announced repurchase program. Recently, the SEC and the media have increased scrutiny of potential insider trading violations by corporate executives who relied on Rule 10b5-1 plans to conduct their trades. Although the SEC has not focused on Rule 10b5-1 plans adopted by companies in connection with a share repurchase program, companies must take care when adopting or modifying such plans.

Rule 10b5-1 Plan Practice Tips

- Plan ahead. Don't wait until the final days of your company's open window to start thinking about a Rule 10b5-1 plan.
- Carefully design plan instructions. Don't assume you can change them or terminate the plan if market conditions or the company's condition, strategy or forecast changes. Frequent modifications to a plan are more likely to invite SEC scrutiny.
- Carefully consider the dates established for transactions, including the potential impact of applicable cooling-off periods. Regular transactions over an extended period are preferable to a small number of large transactions.
- Consider a cooling-off period before any transactions under the Rule 10b5-1 plan will occur.
- Do not enter into a Rule 10b5-1 plan at a time when the company possesses material nonpublic information or, with the benefit of hindsight, may be viewed as possessing material nonpublic information.

Regulation M

How does Regulation M impact a company's share repurchase program?

Regulation M restricts the behavior of a company, its selling shareholders, offering participants and the company's affiliated purchasers during a "distribution" of securities. Those parties, with certain exceptions, are prohibited from bidding for, purchasing or attempting to induce any person to bid for or purchase any security that is the subject of a distribution. The parties are bound by Regulation M for the applicable restricted period that commences either one or five trading days before pricing (depending on trading volume and public float) and continues until the completion of the distribution. Therefore a company that intends to undertake a distribution of securities will need to suspend a repurchase program to comply with Regulation M. If the company is using a 10b5-1 plan, the plan can be written to automatically suspend purchases during the relevant restricted period.

What types of transactions may qualify as "distributions" under Regulation M?

A "distribution" is defined in Rule 100 of Regulation M as "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." A distribution under Regulation M may include public equity offerings, at-the-market offerings, forced conversions of securities, private offerings, tender offers, exchange offers, offerings of convertible or exchangeable securities, and mergers involving the issuance of shares of stock.

Because the definition of "distribution" under Regulation M is complex, a company should consult counsel to determine whether the company is engaged in such an offering before proceeding with, and during the pendency of, a share repurchase program.

Issuer Tender Offers

Some companies may elect to make a tender offer to repurchase their shares. However, most company share repurchases are effected over a period of time through open market purchases and in a manner that avoids characterization as a tender offer to avoid the significant disclosure and substantial procedural requirements under Rule 13e-4 of the Exchange Act to which they are subject. Issuer tender offers may be structured as a "fixed price" tender offer or a "Dutch auction" tender offer in which the company offers to repurchase a fixed maximum number of shares within an identified range of prices. A company may consider making a tender offer in order to repurchase a large number of shares at one time without being subject to the volume limitations under Rule 10b-18.

What constitutes a tender offer?

The term "tender offer" is not defined in U.S. securities law, and there is no bright-line test to determine what constitutes a tender offer. Neither the SEC nor Congress has defined the term. However, several courts have adopted an eight-factor standard initially proposed by the SEC. The courts have consistently ruled that the determination of a tender offer is a fact-based determination. Thus, depending on a company's particular circumstances, the presence or absence of one or more of the following factors will not be dispositive, and one or more of the following factors may be more determinative than the others:

1. The offer includes an active and widespread solicitation of shareholders.
2. The offer involves solicitation of a substantial percentage of the issuer's shares.
3. The offer to purchase is made at a premium over the market price.
4. The terms of the offer are set and not negotiable.
5. The offer is contingent on the tender of a fixed minimum number of shares, often subject to a fixed maximum number to be purchased.
6. The offer is open only for a limited period of time.
7. The offerees are pressured to sell their shares.
8. Public announcements of a repurchase program come before or accompany rapid accumulation of large amounts of the company's securities.

Will a share repurchase program that complies with Rule 10b-18 constitute a tender offer?

Typically, no. A share repurchase program that complies with Rule 10b-18 should not constitute a tender offer because the purchases are made at the prevailing market price and without any solicitation of shareholders. Companies should carefully construct programs that do not take advantage of the safe harbor and monitor them to avoid triggering any tender offer concerns.

What is required of a company contemplating a tender offer?

A company's tender offer must comply with significant disclosure and substantive requirements under Rule 13e-4 of the Exchange Act and additional restrictions, including:

- the offer must remain open for at least 20 business days following commencement;
- the offer must remain open for at least 10 business days following any increase or decrease in the offering price or in the percentage of securities sought;
- the offer must be made to all holders, and all tendering shareholders must receive the highest price paid for any share tendered in the offer;
- the offer must permit tendered securities to be withdrawn as long as the offer is open and, if no longer open but not yet accepted for payment, after the expiration of 40 business days from commencement;
- if the issuer will purchase fewer than all tendered securities, it generally must purchase from tendering security holders pro rata, based on the number of securities tendered by each such holder; and
- before the company may repurchase any other shares, it must observe a cooling-off period of 10 business days after the closing of the tender offer.

Companies making a tender offer are required to file with the SEC a tender offer statement on Schedule TO and amendments to Schedule TO to report any material changes and the final results of the tender offer. The SEC has the discretion to comment on the tender offer [statement] and related materials. In addition, the company must file all written communications it or its affiliates make relating to the tender offer.

What is a "going private" transaction and what are its implications?

The purchase of any equity security by a company or its affiliated purchasers is considered a "going private" transaction and subject to Rule 13e-3 of the Exchange Act if the purchase is intended to or is reasonably likely to cause, either directly or indirectly, the company's common stock to be either (i) held by fewer than 300 persons (based on registered holders, not beneficial holders) or (ii) no longer listed on an exchange or quoted on an interdealer quotation system. If a company's program constitutes a going-private transaction, the transaction will be subject to significant additional timing and disclosure requirements under Rule 13e-3, including disclosure relating to the fairness of the transaction. A company's repurchase program designed to adhere to Rule 10b-18's restrictions typically will not constitute a going-private transaction.

Privately Negotiated Repurchases

A privately negotiated share repurchase is another way for a company to repurchase its shares. Rather than repurchase its shares on an exchange or in the over-the-counter market (*i.e.*, an open market repurchase), a company may decide to enter into share purchase agreements with individual shareholders.

What are the benefits of privately negotiated repurchases and how are they implemented?

Companies may consider entering into one or more privately negotiated repurchases to effect a share repurchase because these arrangements can provide a company a means to repurchase a sizable amount of its shares quickly. However, as the number of shareholders that are approached increases, companies may face significant administration expenses as well as potential illegal tender offer concerns. As a result, privately negotiated repurchases typically are limited to a few sellers. Like all share repurchase programs, privately negotiated transactions also are subject to Rule 10b-5's prohibitions on repurchases made while in possession of material nonpublic information. Often the sellers provide representations and warranties about, among other things, their financial sophistication and knowledge about the company. Sellers also may waive certain claims against a company in connection with a sale.[18]

Are privately negotiated repurchases covered by the Rule 10b-18 safe harbor?

No. In a no-action letter, the SEC declared that privately negotiated repurchases are not eligible for the Rule 10b-18 safe harbor,[19] noting that privately negotiated purchases typically present little potential for manipulative practices and therefore do not require the protection of the safe harbor. Even though a company effectuating a privately negotiated repurchase may not avail itself of the rule's safe harbor, the company must nevertheless consider the applicability of the Exchange Act's general anti-fraud and anti-manipulation provisions. Helpfully, shares repurchased pursuant to a privately negotiated repurchase are not included in a company's daily volume limitation calculation, so a company may privately repurchase shares while also engaged in repurchases on the open market.

Accelerated Share Repurchases (ASRs)

Accelerated share repurchase programs are a popular method companies use to repurchase their shares and are an alternative to open market repurchases, issuer tender offers and standard Rule 10b5-1 trading plans. Structured as bilateral negotiated agreements entered into by companies with bank counterparties, ASRs are documented using the International Swaps and Derivatives Association (ISDA) architecture, including the 2002 ISDA Equity Derivative Definitions.

Structure Overview

In a typical ASR, the company makes an upfront payment to the bank counterparty and the bank counterparty concurrently delivers a number of shares, which the company immediately retires, and which results in an immediate increase in earnings per share. The number of shares is commonly set at 80%-85% of the number of shares equal to the upfront amount (the prepayment amount) divided by the current stock price. In order to satisfy its delivery obligation, the bank counterparty will borrow such shares from stock lenders in the market.

During the term of the ASR, the bank counterparty will purchase shares in the market to close the short position and acquire enough shares for final settlement (if any). Generally, the arithmetic average of the daily volume-weighted average prices (VWAP) during the period the bank counterparty is buying shares will determine the effective price that the company will pay to repurchase its shares, subject to a discount agreed to with the bank counterparty at the inception of the ASR. The company and the bank counterparty will agree on a term for the ASR upon the entry into the program, but the bank counterparty will have the right, on and after an agreed-upon date, to conclude the ASR prior to the scheduled end date. Upon the maturity date, the bank counterparty will typically deliver to the company an additional number of shares.

To the extent that the stock price rises significantly during the term of the ASR, the initial delivery of shares by the bank counterparty may have constituted an over-delivery, as the upfront payment may have been insufficient to purchase the initially delivered shares based on the higher stock price during such period. In that case, the company will be required to return value (in shares or cash) to the bank counterparty at the end of the ASR.

The ASR structure may be tailored for a specific company's goals, including the use of collars, variable notional amounts, knockout features, multibank arrangements and concurrent repurchase plans.

Key Benefits

- While the price the company ultimately pays for its repurchased shares is tied to the average daily VWAP, the company will negotiate a discount to such average daily VWAP in the ASR documentation.
- From an accounting perspective, an ASR consists of an upfront treasury stock transaction, which immediately reduces the numbers of outstanding basic and diluted shares for purposes of earnings-per-share calculations and an equity-linked contract on the company's own stock, but the accounting treatment can be sensitive to the specific terms and provisions of the ASR.
- From a messaging standpoint, relative to other methods of returning capital to shareholders, an ASR provides a clear and strong indication to the market of the company's commitment to repurchase its shares.

Other Considerations

- While purchases made pursuant to an ASR do not fall within the Rule 10b-18 safe harbor, in practice, ASRs are structured to meet many of the rule's requirements, such as not allowing more than one dealer to be in the market purchasing shares on any given day. ASRs are also typically structured as 10b5-1 plans.
- ASRs typically impose limitations on the company's ability to purchase shares outside of the ASR during the term of the ASR, and necessary carve-outs must be negotiated in advance.
- ASRs also typically prohibit companies from taking any action that would cause a restricted period with respect to their shares for purposes of Regulation M during the term of the ASR.
- Significant corporate events, such as assets sales or dispositions, mergers and tender offers, and changes in dividends rates, may give the bank counterparty adjustment and/or termination rights under the terms of the ASR.
- Companies should consider disclosure issues on a case-by-case basis, taking into account materiality, size and any prior disclosure of the authorization for the share repurchase.
- The accounting for ASRs is complicated, and the ASR documentation must be carefully analyzed to ensure that the company obtains the proper accounting treatment. Failure to structure and document the ASR correctly may result in significant undesired accounting consequences. We typically recommend to our clients to seek the advice of the technical accounting team at the inception of the ASR process.

As discussed earlier in this alert, on December 15, 2021, in the SEC Releases, the SEC proposed new amendments to (i) "modernize and improve disclosure" related to an issuer's share repurchases and (ii) add new conditions to expand affirmative defenses available under Rule 10b5-1(c)(1) "to address concerns about the abuse of the rule to opportunistically trade securities on the basis of material nonpublic information."

Conclusion

Many companies face and will continue to face important choices regarding how best to allocate their surplus cash. An increasing number have chosen to repurchase shares of their stock. Companies should assess the legal considerations surrounding share repurchases discussed in this alert in order to make informed decisions. If a company elects to implement a repurchase program, the company should take actions to ensure that the individuals tasked with implementing the program understand the applicable legal (and any contractual) restrictions and requirements and that the necessary processes are in place to maintain compliance. In particular, we recommend that companies adopting new share repurchase programs, trading plans and insider trading policies or considering amendment to their existing programs work with their legal counsel to align each program with the proposed rules in the SEC releases, thereby positioning their plans to comply with such rules immediately upon adoption of the updates.

ENDNOTES

1 Among the causes of increased volatility are: (i) the expiry of fiscal and monetary policies approved in response to the downturn caused by the COVID-19 pandemic; (ii) the U.S. Federal Reserve Board's announcements and actions signaling to the market the board's intention to reduce its balance sheet by steadily tapering its asset purchases and raising interest rates; (iii) the continued reverberations of the COVID-19 pandemic and the potential impact of future variants, including disruptions to global supply chains that in turn kindled generalized inflationary pressures on wages, commodities and consumer goods, which the U.S. economy has not experienced in over 40 years; (iv) the outbreak of hostilities between Russia and Ukraine; and (v) the coordinated geopolitical response of Europe, the United States and other countries imposing economic sanctions on Russia and certain Russian citizens in response to Russia's military invasion of Ukraine.

2 For additional discussion of these proposals, see our December 20, 2021, client alert "SEC Announces Proposals Relating to Rule 10b5-1, Share Repurchases and Other Matters."

3 New disclosures requirements would (i) require daily purchase disclosure on a new Form SR, which issuers would furnish to the SEC one business day after execution of an issuer's share repurchase order; (ii) impose additional disclosure under amended Item 703 of Regulation S-K (Item 703) regarding the structure of an issuer's repurchase program and its share repurchases; (iii) modify the form of reporting required pursuant to Item 703 and Form SR to require using Inline eXtensible Business Reporting Language (Inline XBRL); (iv) require new quarterly disclosure regarding the adoption and termination of Rule 10b5-1 trading arrangements and other trading arrangements of directors, officers and issuers, as well as the terms of such trading arrangements, and require that the disclosure be reported using Inline XBRL; (v) mandate that an issuer disclose in Form 10-K or Form 20-F whether or not (and if not, why not) the issuer has adopted insider trading policies and procedures that govern the purchase, sale or other disposition of the registrant's securities by directors, officers and employees that are reasonably designed to promote compliance with insider trading laws, rules and regulations, and, if the issuer has adopted such policies and procedures, the issuer would be required to (a) disclose such policies and have them be subject to the principal executive and principal financial officer certifications required by Section 302 of the Sarbanes-Oxley Act and (b) tag them using Inline XBRL; (vi) solicit new disclosure regarding grants of equity compensation awards such as stock options and stock appreciation rights (SARs) close to the time of the issuer's disclosure of material nonpublic information (including earnings releases and other major announcements) and require that the disclosure be reported using Inline XBRL; and (vii) require prompt disclosure on Form 4 of dispositions resulting from gifts of securities by insiders within two business days after such a gift is made.

4 A Delaware corporation generally will not be deemed to have impaired its capital if, following the share repurchase, the value of its assets exceeds its liabilities by an amount at least equal to its "stated capital." A corporation's stated capital often is equal to the aggregate par value of all outstanding shares. The amount by which net assets exceeds stated capital is referred to as "surplus." A "revaluation" of assets and liabilities to reflect fair value — a

technique known as "revaluation surplus" — often is utilized by companies seeking to repurchase shares when the historical financial statements do not reflect the availability of adequate surplus.

5 A close review of the company's debt agreements will be important in connection with any potential share repurchase program. In addition to any explicit prohibitions or limitations contained in any debt agreement, the company also must consider how a repurchase could inadvertently and negatively affect its financial ratios.

6 Stock exchange rules regarding advance notice of material corporate developments and other filings may apply.

7 Foreign private issuers are required to report their repurchases pursuant to Item 16(e) of Form 20-F, and closed-end management investment companies that are registered under the Investment Company Act of 1940 must report their repurchasing activity pursuant to Item 9 of Form N-CSR. 17 C.F.R. § 240.10b-18.

8 Under Rule 10b-18, a person or entity is an "affiliated purchaser" if it (i) acts, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities or (ii) is "an affiliate who, directly or indirectly, controls the issuer's purchases of such securities, whose purchases are controlled by the issuer, or whose purchases are under common control with those of the issuer; provided, however, that 'affiliated purchaser' does not include a broker, dealer, or other person solely by reason of such broker, dealer, or other person effecting Rule 10b-18 purchases on behalf of the issuer or for its account, and does not include an officer or director of the issuer solely by reason of that officer or director's participation in the decision to authorize Rule 10b 18 purchases by or on behalf of the issuer."

9 Rule 10b-18(b)(1) states that the "one broker or dealer" requirement will not apply to purchases that were not solicited by or on behalf of a company or its affiliated purchasers. The rule also requires that, in the event Rule 10b-18 purchases are made by or on behalf of more than one affiliated purchaser (or a company and one or more of its affiliated purchasers) on a single day, the issuing company and its affiliated purchasers must use the same broker or dealer. Moreover, where Rule 10b-18 purchases are made on a company's behalf by a broker-dealer that is not an electronic communication network (ECN) or other alternative trading system (ATS), that broker-dealer is permitted to access ECN or other ATS liquidity in order to execute repurchases on behalf of the company (or any affiliated purchaser) on that day.

10 The SEC has stated that in calculating the dollar value of ADTV, any reasonable and verifiable method may be used. The value is generally derived from multiplying each day's volume of shares (the volume publicly reported during the four calendar weeks preceding the week in which the Rule 10b-18 purchase is effected) by the closing price on that day, but may also be derived from multiplying the number of shares by the price in each trade. ADTV should be calculated on a per-share basis (as opposed to a dollar basis).

11 However, under Rule 10b-18(b)(2), repurchases may be made after the close of the primary trading session until the end of the period in which last sale prices are reported in the consolidated system, as long as such purchases (i) satisfy the rule's requirements and (ii) are made at prices that do not exceed the lower of the closing price of the primary trading session in the security's principal market and any lower bids or sale prices subsequently reported in the consolidated system. During this period, the one broker or dealer requirement still applies, but a company is permitted to make Rule 10b-18 purchases using a different broker or dealer from the one used during the primary trading session. However, the company's purchase may not be the opening transaction of the session following the close of the primary trading session.

12 "Block" trades are defined by Rule 10b-18(a)(5) to include: (i) purchases of at least $200,000; (ii) purchases of at least 5,000 shares that have a purchase price of at least $50,000; or (iii) purchases of at least 20 round lots of a security where the purchased quantity represents 150% or more of the trading volume for that security (if trading volume data is available), and, if trading volume data is not available, at least 20 round lots of the security that total at least .001% of the outstanding shares of the security, exclusive of any shares owned by an affiliate.

13 Rule 10b-18(b)(4).

14 In the event that a security's transaction prices are not quoted or reported in the consolidated system, Rule 10b-18(b)(3) requires that purchases of the security not exceed the highest independent bid or the last independent transaction price, whichever is higher, displayed on any national securities exchange or any interdealer quotation system that displays at least two priced quotations for the security, at the time the purchase is made. For all other securities, purchases made under the rule must not exceed the highest bid obtained from three independent dealers.

15 Under Rule 10b-18(a)(13), the merger exclusion does not apply when: (i) the purchase price is solely cash and there is no valuation period with respect to the purchase price; (ii) the repurchases made on any single day do not exceed the lesser of 25% of the security's four-week ADTV or the issuer's average daily Rule 10b-18 purchases during the three full calendar months preceding the announcement of the transaction; or (iii) the repurchases are block purchases that do not exceed the average size and frequency of the company's "block" purchases during the three full calendar months preceding the announcement of the transaction.

16 Under Rule 10b-18, the issuing company's corporate officers or directors are not affiliated purchasers simply because they participated in the decision to authorize a Rule 10b-18 program, although they may still otherwise qualify as affiliated purchasers. Furthermore, the target company of an acquirer may

be deemed an affiliated purchaser with respect to purchases of the acquirers' securities after signing a merger agreement. *See* SEC Staff Legal Bulletin No. 9 (Oct. 27, 1999).

17 Currently there is no specific requirement regarding the amount of time in advance, if any, a company must adopt a Rule 10b5-1 plan before the company can make its first repurchase. However, as mentioned in footnote 3, the SEC recently proposed establishing 30-day and 120-day cooling-off periods for issuers and company insiders under the Rule 10b5 1 and Insider Trading releases, respectively.

18 Selling shareholders may waive their claims against the company in a negotiated agreement that is colloquially referred to as a "big boy letter" (although the relevant provisions could be included in the purchase agreement related to the sale). In the context of a share repurchase, a big boy letter is an agreement in which the company and a selling shareholder acknowledge that the company may possess material, nonpublic information that it has not disclosed, the two parties agree to enter into the transaction regardless of the information disparity and the seller agrees to waive any claims related to this information disparity. Big boy letters have received significant attention because while they can aid parties in allocating risk, the case law is mixed on whether they are enforceable in a private action or whether they constitute a violation of Section 29(a) of the Exchange Act, which states, "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void." Regardless of a big boy letter's enforceability in a private action, the SEC has taken the position that such a letter will not preclude an SEC enforcement action.

19 SEC No-Action Letter, *General Electric Co*. (August 3, 1984).

This post comes to us from Skadden, Arps, Slate, Meagher & Flom LLP. It is based on the firm's memorandum, "Revisiting Share Repurchases in Volatile Times," dated March 17, 2022, and available here.

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