

STOCK BUYBACKS: Misconceptions and the Truth

BETSY WILLS
VP EDUCATION, ROCKY MOUNTAIN CHAPTER
BETTER INVESTING

What are Stock Buybacks?

- Stock buybacks or stock repurchases are simply the re-acquisition by a company of its own stock in the public market
 - Repurchased shares can either be kept on the books as “treasury shares” or returned to “authorized but unissued” status
- Repurchases must be authorized and approved by the board of directors – not up to the officers or management
- Some states also have provisions restricting the type of corporate funds that may be used to repurchase stock

2

Why Would a Company Repurchase its Stock?

- Alternative method of returning cash to shareholders:
 - Dividends return cash to all shareholders
 - Buybacks return cash only to the selling shareholders
- Take advantage of share undervaluation
 - Repurchase shares when market price is down
- Alert investors that company thinks stock is undervalued, and therefore a good time to buy
- Offset the dilutive impact of exercises of employee stock options and/or merger and acquisition activity involving the issuance of shares
- Make company more attractive to investors
 - Reducing the number of outstanding shares increases EPS

3

Misconception: Management Can Repurchase Stock Whenever They Want to in Order to Manipulate the Stock Price

- Why would a company want to manipulate the price of its common stock or EPS?
 - May be planning an acquisition or offering of new shares of its stock
 - To meet or exceed earnings per share estimates

4

Anti-Fraud Provisions of Federal Securities Laws Apply to Stock Manipulation

- Sections 9(b) and 10(b) of the Securities and Exchange Act of 1934 prohibit fraudulent and manipulative practices in connection with an issuer's or "affiliated purchaser's" purchase and sale of the issuer's securities
 - Rule 10b-5 makes it unlawful for any person, directly or indirectly, (i) to "employ any device, scheme or artifice to defraud," (ii) to make false and misleading statements of material facts or omit to state material facts, or (iii) to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person"
 - "Affiliated Purchaser" is anyone acting directly or indirectly in concert with the issuer to purchase the issuer's securities or any person who controls the issuer's purchases of its securities (i.e., directors, officers and 10% or more shareholders)

5

SEC Rule 10b-18 Governs Stock Repurchases

- Adopted in 1982, amended 2003
- Voluntary – not mandatory
- Provides a "safe harbor" for companies and their affiliated purchasers when the company or affiliates repurchase the company's shares of common stock
 - "Safe harbor" means the company or affiliates will not be deemed to have violated the anti-fraud provisions of the Securities Exchange Act of 1934
 - Only applies to repurchases by a company of its common stock or equivalent
- Not exclusive
- No immunity from liability under Section 10(b) or Rule 10b-5 if the company repurchases while in possession of material, non-public information or if part of plan or scheme to evade federal securities laws
- The repurchases must fall within the four (4) conditions of the rule
 - Each of the four (4) conditions must be satisfied daily – otherwise, repurchases will not fall under safe harbor for that day
 - If exceed the limitations of Rule 10b-18, not automatically incur liability – however, greater uncertainty because purchases are outside safe harbor

6

Repurchase Conditions under Rule 10b-18

- **Manner of purchase:** The issuer or affiliate must use a single broker or dealer per day to bid for (solicit) or purchase its stock
- **Timing:** the purchases must **not** be the opening transaction, and
 - An issuer with an average daily trading volume (ADTV) of \$1 million or more per day and a public float value of \$150 million or more can purchase up until the last 10 minutes before the scheduled close of trading
 - Companies with lower ADTV or public float value are unable to purchase within the last 30 minutes before the scheduled close
- **Price:** The issuer must repurchase at a price that does not exceed the highest independent bid or the last transaction price (whichever is higher) quoted or reported at the time the purchase is made
- **Volume:** The issuer can't purchase more than 25% of the average daily volume on any given day
 - Block trades typically included in computing ADTV
 - Once per week, instead of purchasing under 25% of ADTV limit, a company can make one block trade without regard to volume limit, provided it is the only Rule 10b-18 purchase made on that same day

7

How to Ensure Compliance with Rule 10b-18?

- Adopt a stock repurchase plan structured to comply with Rule 10b5-1 safe harbor
- A Rule 10b5-1 plan provides instructions to a broker/dealer to effect repurchases at a later date
 - No specific rule regarding the amount of time, if any, that must elapse between the adoption of a 10b5-1 plan and its first repurchase
 - Allows a company to continue repurchasing its shares in the open market while in possession of material non-public information
 - Provides an affirmative defense to a charge that the company was aware of material non-public information when any such repurchases were effected
- Is a binding contract
- Most large broker/dealers have plan templates

8

Conditions of a Rule 10b5-1 Stock Repurchase Plan

- The contract or written plan must be entered into at a time when the company is not in possession of material non-public information (i.e., during an “open window period”)
- Plan must set trading criteria or set a formula for the amount, price and date of purchases, or delegate those decisions to the broker/dealer
- Plan must not permit the Company to exercise subsequent discretion as to amount, price or dates of trades, or whether to effect purchases
- Plan must be entered into in good faith
- Purchases must actually be made pursuant to the trading plan

9

Should a Company Publicly Announce a Stock Repurchase Plan?

- Rule 10b-18 does not require a company to publicly disclose a stock repurchase program
- But provisions of other federal securities laws still apply, including Rule 10b-5
- Therefore, is advisable for a company to announce the existence of a significant stock repurchase program
 - However, no announcement should be made unless the company actually intends to repurchase shares
 - A termination of the repurchase program without purchases could be deemed manipulative in the absence of a sound business reason
 - Company should file a Form 8-K Current Report with press release disclosing establishment of a plan, but not complete details
 - Actual plan does not have to be filed with SEC

10

Reporting Requirements for Company Stock Repurchases

- SEC rules require quarterly periodic disclosure of all company repurchases in Forms 10-Q and 10-K:
 - Total number of shares, by month, repurchased during the past quarter
 - Average price paid per share;
 - Number of shares that were purchased as part of a publicly announced repurchase plan;
 - Maximum number (or approximate dollar value) of shares that may yet be purchased as part of a publicly announced repurchase plan; and
 - Additional disclosures required for publicly announced repurchase plans
- Disclosure required regardless of whether repurchases are made under safe harbor of 10b-18 or otherwise

11

Recent Legislative Developments

- Senator Tammy Baldwin (D-Wis) introduced The Reward Work Act on March 22, 2018 that would “prohibit public companies from repurchasing their shares on the open market”
 - Would repeal SEC Rule 10b-18
 - Wants companies to share extra cash with workers instead of rewarding shareholders
 - Argues buybacks “deepen the chasm between America’s rich and poor because affluent families own the vast majority of the stocks” – money would be better spent by investing in the future, paying workers more or offering better benefits and retraining programs
 - Act would also require public companies to give workers the right to directly elect one-third of their company’s board of directors

12

Additional Information

- Text of Rule 10b-18:
<https://www.law.cornell.edu/cfr/text/17/240.10b-18>
- Text of Rule 10b5-1:
<https://www.law.cornell.edu/cfr/text/17/240.10b5-1>
- SEC FAQ:
<https://www.sec.gov/divisions/marketreg/r10b18faq0504.htm>
- Sample 10b5-1 and 10b-18 Plan:
<https://www.sec.gov/Archives/edgar/data/29332/000002933208000070/ex991repurchaseagre.htm>

13

THANK YOU!

14