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September 2, 2014

Public Company and Affiliate Stock Buyback Rules; Rule 10b-18

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

The SEC allows for limited methods that an issuer can utilize to show confidence in its own stock and assist in maintaining or increasing its stock price. One of those methods is Rule 10b-18 promulgated under the Securities Exchange Act of 1934, as amended ("Exchange Act"). Exchange Act Rule 10b-18 provides issuers with a non-exclusive safe harbor from liability for market manipulation under Sections 9(a)(2) and 10(b) and Rule 10b-5 under the Exchange Act when issuers bid for or repurchase their common stock in the open market in accordance with the Rule's manner, timing, price and volume conditions. Each of the four main conditions of Rule 10b-18 must be satisfied on each day that a repurchase is made.

Sections 9 and 10 of the Exchange Act are the general anti-fraud and anti-manipulation provisions under the Act. Section 9(a)(2) of the Exchange Act makes it unlawful for any person to, directly or indirectly, create actual or apparent active trading in a security or raise or depress the price of such security for the purpose of inducing the purchase or sale of such security by others.

Section 10(b) of the Exchange Act makes it unlawful for any person to, directly or indirectly, "use or employ, in connection with the purchase or sale of any security… any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5, promulgated under Section 10(b), provides that "[I]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to

defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Although Rule 10b-18 provides a safe harbor from the liability provisions of Section 9(a)(2), 10 and Rule 10(b)(5), like most securities rules, the rule does not provide protection from liability where it is utilized as part of a plan or scheme to evade the securities laws. In addition, an issuer must consider the interaction of other basic securities laws when attempting to rely on Rule 10b-18, such as whether it is in possession of material non-public information.

Rule 10b-18

Prior to relying on Rule 10b-18, the issuer's board of directors must approve the plan. The board minutes should include the purpose of the plan and disclose the benefits to the corporation and its shareholders in proceeding with the repurchase program.

The issuer should also consider whether it will publicly announce the program. Rule 10b-18 does not specifically require announcement, but the issuer must consider overall public disclosure requirements. Generally, if the issuer is embarking on a repurchase program, it should be announced, as the failure to announce could be deemed material non-public information preventing the program itself. Moreover, likewise if a program is announced and subsequently terminated, the termination should be announced. An announcement would be in the form of a press release and Regulation FD Form 8-K filing with such release.

The material portions of Rule 10b-18 are as follows:

Definition. A "Rule 10b-18 purchase" is generally defined as an open market purchase or any bid or limit order of an issuer's common stock by or for the issuer or any of the issuer's affiliated purchasers. The Rule is limited to common stock and does not cover other forms of securities such as warrants, options, debt or preferred stock.

To be able to rely on Rule 10b-18 in making repurchases, the following four (4) conditions must be met.

Time of Purchase. The Rule restricts issuers from making repurchases that constitute the opening transaction in the security on a trading day, or subject to exceptions, that occur during the last 30 minutes before the scheduled close of trading. However, the limitations on purchases at the close vary depending on the average daily trading volume ("ADTV") and public float. Issuers with more liquid securities (i.e., issuers with an ADTV of $1 million or more and a public float value of $150 million or more) would not be restricted from bidding for or purchasing their securities during any of the following periods: (1) in the 10 minutes before the scheduled close of the regular trading session in the principal market for the security; (2) the 10 minutes before the scheduled close of the regular trading session in the market where the purchase is made; and (3) after the termination of the period in which last sales prices are reported in the consolidated system.

Price of Purchase. The purchase price cannot exceed the higher of the highest independent bid or the last independent transaction price. For after-hours trading, the price must not exceed the lower of the closing price of the primary trading session or principal market and the price of any other reported subsequent transactions. The price restrictions do not apply provided that (i) the purchase otherwise complies with the Rule; (ii) the security is an actively traded security as defined in Regulation M (i.e., issuers with an ADTV of $1 million or more and a public float value of $150 million or more); (iii) the purchase is entered into or matched before the opening of the regular trading session; (iv) the execution price of the VWAP purchase based on regular trades meets specified conditions; (v) the purchases do not exceed 10% of the issuer's ADTV; (vi) the purchase is not for the purpose of creating an actual or apparent active trading market; (vii) the VWAP calculation is in accordance with the Rule; and (viii) the purchase is recorded using a special VWAP code (so as not to sway the independent market).

Volume of Purchase. The Rule limits the amount of securities an issuer may repurchase on the market on a single day to 25% of the four-week average daily trading volume in its shares (that is, the average daily trading volume during the four calendar weeks prior to the week in which the 10b-18 purchase is to be made). However, issuers are permitted to make one block purchase of its common stock per week outside of the volume restrictions. Issuers have to include block purchases in applying the 25% volume limitation. However, issuers would also be permitted to include block purchases in calculating the ADTV for their securities, thereby increasing

the amount of stock able to be purchased within the safe harbor. The Rule defines a "block" as a quantity of stock that (1) has a purchase price of $200,000 or more, (2) is at least 5,000 shares and has a purchase price of at least $50,000, or (3) is at least 20 round lots of the security and totals 150% or more of the ADTV of that security. As an alternative to the 25% volume limitation, issuers are allowed purchase up to a daily aggregate amount of 500 shares regardless of the ADTV of the security. Thus, an issuer's purchases, on any single day, may not exceed the higher of 25% of the ADTV for the issuer's security or a daily aggregate amount of 500 shares.

Manner. The Rule requires an issuer to use only one broker or dealer per day to bid for or purchase its common stock. The issuer may utilize a different broker on different days, as long as they only use one per day. The issuer's direct use of an electronic trading platform or alternative trading system will be considered using a broker for purposes of applying the rule. Moreover, an issuer is not prohibited from closing unsolicited private transactions involving the repurchase of a shareholder's securities in addition to its open-market purchases.

Benefits of a stock repurchase program

There are many reasons why an issuer or an affiliate of an issuer may want to purchases its stock in the open market. In particular, (i) the repurchase of stock in the open market shows confidence and a belief in the value of the stock; (ii) like all purchases, can tend to drive up the stock price; (iii) can reduce the cost of capital for the issuer; (iii) supports liquidity for all shareholders; (iv) can be used to signal a belief that the stock is undervalued; (iv) reduce dilution after an acquisition or other large issuance; and (v) is a way to return cash to shareholders.

State law and other considerations

Prior to embarking on a repurchase program, the issuer must review its charter, bylaws and material contracts and, in particular, financing contracts. Each of these documents could contain provisions that directly or indirectly prohibit or otherwise affect an issuer's ability to repurchase its own securities.

Stock repurchase programs do not pre-empt state law. Many states have provisions related to the issuer's ability to repurchase its own stock. For example, Delaware law provides that a company may not purchase shares of its stock when the purchase "would cause any impairment of the capital of the corporation." A repurchase is often

considered analogous to a dividend under state law (by purchasing stock from shareholders, the issuer is providing cash to such shareholder). The dividend provisions of the state of incorporation should always be reviewed for compliance. Many states prohibit a dividend, including through the repurchase of securities, in the event the company is technically insolvent or fails to meet certain basic balance sheet tests such as the ratio of assets to liabilities or the amount of retained earnings.

General creditors' rights should be considered as well. For example, a creditor could attack a repurchase program when such a program leaves the issuer without available cash to meet its obligations or is seen to otherwise impair such creditor's ability to be repaid, or its security under a security agreement. It is fairly common for complex financing transactions to prohibit or otherwise limit such stock repurchases, including indirectly through limits on the use of excess cash.

Reporting requirements related to repurchases

All issuers that are subject to the Exchange Act reporting requirements must report their stock repurchases in their Forms 10-Q and 10-K. Item 703 of Regulation S-K requires that an issuer disclose in tabular form (a) the period of purchases, by month; (b) the total number of shares repurchased during the past quarter, separated by month; (c) the average price paid per share; (d) the number of shares that were purchased as part of a publicly announced repurchase plan; and (e) the maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs.

For publicly announced repurchase plans, the issuer is also required to disclose (by footnotes to the table) the following information: (a) the announcement date; (b) the share or dollar amount approved; (c) the expiration date (if any) of the plans or programs; (d) each plan or program that has expired during the period covered by the table; and (e) each plan or program terminated prior to expiration or the program.

Repurchase programs should also be discussed under the issuer's management discussion and analysis (MD&A) disclosures. The reasons for embarking on the program are material and relevant to the issuer's plans of operations and belief in the value of the company. In addition, the use of cash for such a program is material to the liquidity discussion.

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the Producer and host of LawCast.com, The Securities Law Network.

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