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STRUCTURING SHARE REPURCHASES: RULE 10b-18 AND RULE 10b5-1 APPLIED TO VARIOUS OPEN-MARKET REPURCHASE PROGRAMS

Share repurchase programs are a tool used by many public companies to return capital to shareholders. This article examines how Rule 10b-18 and Rule 10b5-1 of the Securities Exchange Act of 1934 operate. It then discusses how OMR, ASR, and eOMR transactions work. Lastly, it analyzes the extent to which Rule 10b-18 and Rule 10b5-1 may apply to each of these types of transactions.

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Share repurchase (or share buyback) programs are a tool used by many public companies to return capital to shareholders. Once a public company has resolved to initiate share repurchases, the focus turns toward structuring the share repurchase program. There are many types of transactions available to execute share repurchases. Transaction structures range from relatively simple open-market share repurchases (“OMR”) to more complex accelerated share repurchase transactions (“ASR”), with enhanced open-market share repurchases (“eOMR”) serving as a hybrid in between. From a legal perspective, it is important to determine whether the desired share repurchase transaction may take advantage of the legal protections offered by the Rule 10b-18 safe harbor and Rule 10b5-1.

To build a framework to understand share repurchase alternatives, first let’s examine how Rule 10b-18 and Rule 10b5-1 operate. Next, let’s examine how OMR, ASR and eOMR transactions work and highlight certain notable features of these transactions. Then, let’s analyze

the extent to which Rule 10b-18 and Rule 10b5-1 may apply to each of these types of transactions.

COMMERCIAL FEATURES THAT DISTINGUISH SHARE REPURCHASE TRANSACTIONS

When a public company evaluates various share repurchase alternatives, some helpful things to consider are:

- The level of control over the daily spend of the share repurchase activity;
- The ability to terminate the share repurchase activity;
- The ability to receive a large upfront delivery of shares;
- Whether to use a derivative transaction to effect share repurchase activity; and

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- The ability for such share repurchase activity to qualify for the Rule 10b-18 safe harbor and/or constitute a Rule 10b5-1 plan.

RULE 10b-18 AND RULE 10b5-1 PUT INTO CONTEXT

Compliance with Rule 10b-18 and Rule 10b5-1(c) serve related, but distinct, purposes to ensure that share repurchase activity does not run afoul of federal securities laws. A helpful way to think of Rule 10b5-1 is to consider it as a shield to an insider trading claim. In comparison, Rule 10b-18 is a shield to a claim that the share repurchase activity was conducted in a manipulative or deceptive way.

Rule 10b-18

Rule 10b-18¹ provides a non-exclusive safe harbor from liability under certain anti-manipulation provisions of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) and its associated rules. Rule 10b-18 applies on a daily basis and, to benefit from the safe harbor, all of a public company’s eligible share repurchase activity on such day must satisfy each of Rule 10b-18’s four conditions.² Failure to meet any one of the four conditions disqualifies all of the public company’s eligible repurchase activity from the safe harbor for that day.³ So, Rule 10b-18 applies one day at a time and is an all-or-nothing proposition for eligible share repurchases.

The four conditions of Rule 10b-18 are:

- One broker rule: The public company and its affiliated purchasers use only one broker-dealer on any given day to bid for or purchase shares of its common stock.⁴

- Timing: The purchase may not constitute the opening transaction or occur during the last half hour of trading (or the last 10 minutes of trading, if the stock has an average daily trading volume (“ADTV”) of \$1 million or more during the four weeks preceding the week in which the purchase occurs, and the public company has a public float value of \$150 million or more).⁵
- Price: The purchase price is not higher than the higher of (1) the greatest independent bid and (2) the last independent transaction price, in each case at the time of the purchase.⁶
- Volume: The aggregate amount of the purchases by the public company per day does not exceed 25% of the stock’s four-week ADTV. Public companies are also permitted to make one block purchase of stock per week outside the volume limit, so long as they do not make any other 10b 18 purchases that day.⁷

The types of share repurchases eligible for the Rule 10b-18 safe harbor are open-market purchases, effected on behalf of the public company and executed on an agency or riskless principal basis.⁸ Accelerated share repurchases, forward contracts, and the like are private (off-market) transactions, not eligible for the Rule 10b-18 safe harbor.⁹ If a public company’s share repurchase activity on a given day is comprised of both open-market share repurchases and privately negotiated share repurchases, it may effect such privately negotiated share repurchases (which are outside the safe harbor) without jeopardizing the availability of the safe harbor for its open-market share repurchase activity.¹⁰

¹ Rule 10b-18 of 1934 Act Rules.

² Question 6 to Rule 10b-18 FAQs.

³ Question 6 to Rule 10b-18 FAQs.

⁴ Rule 10b-18(b)(1).

⁵ Rule 10b-18(b)(2).

⁶ Rule 10b-18(b)(3).

⁷ Rule 10b-18(b)(4).

⁸ Question 13 to Rule 10b-18 FAQs.

⁹ Question 13 to Rule 10b-18 FAQs.

¹⁰ Question 3 to Rule 10b-18 FAQs.

Rule 10b5-1

Rule 10b5-1 sets forth a definition for trading on the basis of material non-public information, and Rule 10b5-1(c) sets forth the requirements of a “Rule 10b5-1 plan.” A Rule 10b5-1 plan provides an affirmative defense against an insider trading claim.

As background, Section 10(b) of the Exchange Act prohibits the use of “any manipulative or deceptive device or contrivance” in connection with the purchase or sale of any security registered on a national securities exchange.¹¹

Per Rule 10b5-1(a), “manipulative or deceptive device(s) or contrivance(s)” prohibited by Section 10(b) include, among other things, the purchase or sale of a security of any public company, ‘on the basis of’ material nonpublic information about that security or public company, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the public company or the shareholders of that public company, or to any other person who is the source of the material nonpublic information.¹² Per Rule 10b5-1(b), subject to the affirmative defenses in Rule 10b5-1(c), a purchase or sale of a security is on the basis of material nonpublic information if the person making the purchase or sale was “aware” of the material nonpublic information when the person made the purchase or sale.¹³

In order to limit the risk of insider trading liability, a public company may enter into a Rule 10b5-1 plan to purchase its securities. Rule 10b5-1(c) sets forth the requirements of a Rule 10b5-1 plan. In the case of a public company, a Rule 10b5-1 plan must have been entered into at a time at which the public company was not aware of any material nonpublic information,¹⁴ must have been entered into in good faith and not as part of a plan or scheme to evade the prohibitions of the Exchange Act, and the public company must act in good faith with respect to the Rule 10b5-1 plan.¹⁵

The requirements of a Rule 10b5-1 plan are:¹⁶

- Writing: The Rule 10b5-1 plan must be one of (1) a binding contract to repurchase shares; (2) an instruction to another person to repurchase shares for the public company’s account; or (3) an otherwise written plan for repurchasing shares.¹⁷
- Predetermined methodology for repurchases: The Rule 10b5-1 plan must (1) specify the amount(s), price(s) and date(s) of such repurchases; (2) include a written formula or algorithm, or computer program, for determining the amount(s), price(s), and date(s) of such repurchases; or (3) not permit the public company to exercise any subsequent influence over how, when, or whether to effect repurchases (and whoever does execute repurchases also must not have been aware of any material nonpublic information when executing such repurchases).¹⁸
- No subsequent deviations: The public company cannot alter or deviate from the Rule 10b5-1 plan (whether by changing the amount, price, or timing of repurchases), or enter into or alter a corresponding or hedging transaction or position with respect to share repurchases.¹⁹

Rule 10b5-1(c) limits the ability of a public company to amend a Rule 10b5-1 plan. Any modification or change to the amount, price, or timing of repurchases under a Rule 10b5-1 plan is deemed a termination of such Rule 10b5-1 plan and an adoption of a new Rule 10b5-1 plan.²⁰

STRUCTURING A SHARE REPURCHASE TRANSACTION TO BENEFIT FROM RULE 10b-18 AND RULE 10b5-1 PROTECTIONS

To qualify for the Rule 10b-18 safe harbor, a share repurchase transaction must be done on an agency or riskless principal basis, where the shares are purchased in the open market.

¹¹ Section 10(b) of the Securities and Exchange Act of 1934.

¹² Rule 10b5-1(a).

¹³ Rule 10b5-1(b).

¹⁴ Rule 10b5-1(c)(1)(i)(A).

¹⁵ Rule 10b5-1(c)(1)(ii)(A).

¹⁶ Rule 10b5-1 plans entered into by persons other than issuers are subject to additional requirements not discussed herein.

¹⁷ Rule 10b5-1(c)(1)(i)(A).

¹⁸ Rule 10b5-1(c)(1)(i)(B).

¹⁹ Rule 10b5-1(c)(1)(C).

²⁰ Rule 10b5-1(c)(1)(iv).

When a broker-dealer repurchases as agent, it buys shares from third parties and such purchases are not executed in, and do not otherwise pass through, such broker-dealer's proprietary account. Compensation for agency share repurchases typically is paid in the form of a commission.

Rule 10b-18 defines a riskless principal transaction as a transaction in which a broker-dealer, after having received an order from a public company to buy its shares, buys such shares as principal in the market at the same price to satisfy the public company's buy order. The public company's buy order must be effected at the same price per-share at which the broker-dealer bought shares to satisfy the public company's buy order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee. Rule 10b-18 further requires that the broker-dealer must have written policies and procedures in place to assure that, at a minimum, the public company's buy order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal account or the public company's account within 60 seconds of the execution; and the broker-dealer has supervisory systems in place to produce records that enable the broker-dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders effected on a riskless principal basis.²¹

In order for a share repurchase transaction to qualify for protection under a Rule 10b5-1 plan, such transaction must meet the requirements of Rule 10b5-1 plans. Namely, that it must be reduced to writing, set forth a predetermined methodology to execute share repurchases, and there must not be any alterations to our deviations from the 10b5-1 plan.

PARTICULAR TYPES OF TRANSACTIONS USED TO EXECUTE SHARE REPURCHASE PROGRAMS

Open-Market Transactions

OMR is the simplest form of a share repurchase transaction. To execute OMR, a public company will typically place an order with a broker-dealer's share repurchase desk, who will typically repurchase the shares on an agency or riskless principal basis, in compliance with Rule 10b-18. Most broker-dealers have a form of Rule 10b-18 agreement that is meant to be an "evergreen" document and sets forth the terms of such Rule 10b-18 repurchases.

If a public company is headed into a closed-window period (or "blackout") and wishes to continue share repurchase activity, a public company would execute a Rule 10b5-1 plan that would govern the terms of such share repurchases. Rule 10b5-1 plans generally are not utilized for repurchases during an open-window period since the public company has already determined that it is not aware of any material nonpublic information.

OMR provides the greatest level of control over share repurchase activity, as the public company dictates the prices and times at which shares are repurchased. OMR also allows the share repurchase activity to be terminated at any time. However, OMR does not allow for a large upfront delivery of shares to be repurchased since OMR is "cash and carry."

Accelerated Share Repurchases

General Description of an ASR

An ASR is among the most prevalent forms of derivative repurchase transactions. It is a "forward" transaction, where the public company prepays the purchase price of the program, and the investment bank delivers an amount of shares equal to the simple average of the daily volume-weighted average prices of market-wide Rule 10b-18 compliant transactions ("daily Rule 10b-18 VWAP") observed during the term of the transaction (the "average Rule 10b-18 VWAP") minus a pre-agreed discount (the "Discount"). Typically, the majority of the shares repurchased are delivered at the initiation of an ASR, with the remainder delivered at the conclusion of an ASR. To accomplish this upfront delivery, the investment bank will typically borrow such 'upfront shares' from share lenders in the stock-loan market. The Discount represents the payment an investment bank makes to the public company for the options the public company sells to the investment bank under an ASR.

An ASR generally also provides the investment bank with the ability to end the transaction on a day of its choosing, subject to a minimum and maximum transaction term.

Since a public company is effectively selling its share repurchase activity to an investment bank under an ASR, it relinquishes control over the daily spend of share repurchase activity and control to designate a termination date for the share repurchase activity. However, an ASR does provide a public company with the ability to receive a large upfront delivery of shares to be repurchased and certainty that the per-share repurchase price will be a discount to the average Rule

²¹ Rule 10b-18(a)(12).

10b-18 VWAP during the term of an ASR (subject to any lookback option, as described below).

Options Embedded in an ASR

One way to think about the options embedded in an ASR is to view an ASR as a vehicle through which a public company sells a share repurchase execution to an investment bank. A share repurchase execution may be decomposed as a bundle of options.

One such option, a “Rule 10b-18 VWAP put option,” is the right a public company grants to an investment bank to put shares to such public company at the average Rule 10b-18 VWAP.

A second option, a “timing option,” grants an investment bank the ability to determine the duration of the ASR, subject to a minimum and maximum duration. The timing option allows an investment bank more flexibility to vary the amount of shares it repurchases on any given trading day.

A third option in many ASRs is a “lookback option” that allows an investment bank to omit the daily Rule 10b-18 VWAP observed on the date that it exercises its ability to end the ASR early from the average Rule 10b-18 VWAP. In a scenario where the share price trades down materially on a given day during the exercise period, a lookback option allows an investment bank to capture the full difference between the lower spot price of the shares on such exercise date and the average Rule 10b-18 VWAP.

A rough way to think about a Discount is that it represents the values of the options embedded in an ASR and the value of any dividends paid on the shares, minus the cost to borrow the upfront shares. A public company may also customize the structure of an ASR to offer a subset of the options discussed or other potential options not discussed.

Rule 10b-18 and Rule 10b5-1 Applied to ASR

ASRs do not qualify for the Rule 10b-18 safe harbor but are generally structured to meet the requirements of a Rule 10b5-1 plan. Although ASRs do not qualify for Rule 10b-18 coverage, ASRs may be legally structured to reduce the risk that an ASR and related market activity could be alleged to be manipulative.

Enhanced Open-Market Repurchases—Somewhere Between OMR and ASR

An eOMR is a share repurchase transaction that is designed to operate like an OMR but allows a public

company to effectively sell the Rule 10b-18 VWAP put option and timing option embedded in its share repurchase activity to an investment bank. Accordingly, a public company relinquishes control over the daily spend of share repurchase activity under an eOMR.

eOMR does provide a public company with the ability to terminate at any time. However, if the public company terminates the eOMR, the investment bank may be relieved from the reimbursement obligation for potential underperformance described below, but the public company remains liable for the potential outperformance payment described below.

General Description of eOMR

Under an eOMR, a public company typically enters into a contract structured to satisfy the requirements of a Rule 10b5-1 plan. The contract grants discretion to the investment bank to determine the amount of shares repurchased on any trading day up to the Rule 10b-18 volume limit. Such daily purchases are settled normal course like OMR. An eOMR does not provide for any upfront delivery of shares. In the same manner as an ASR, discretion is granted to the investment bank to determine the end of the program, which represents the sale of a timing option.

At the conclusion of an eOMR, a final calculation is done which compares the difference between the volume-weighted average purchase price of shares repurchased under the eOMR (the “eOMR VWAP”) to the average Rule 10b-18 VWAP observed during the term of the eOMR. If the eOMR VWAP is greater than such average Rule 10b-18 VWAP (i.e., the investment bank underperformed), the investment bank rebates such excess to the public company. Conversely, if such average Rule 10b-18 VWAP is greater than the eOMR VWAP (i.e., the investment bank outperformed), the public company pays a pre-agreed percentage of such excess to the investment bank.

Economically, like an ASR, an eOMR allows a public company to sell a Rule 10b-18 VWAP put option and a timing option to an investment bank. The consideration the public company receives from these sales is the certainty that it will pay no more than the average Rule 10b-18 VWAP observed during the term of the eOMR, and potentially less to the extent that shares are repurchased at a price better than the average Rule 10b-18 VWAP. Unlike an ASR, under an eOMR, a public company may only repurchase shares at a discount to the average Rule 10b-18 VWAP to the extent the share repurchase activity is executed at a discount to the average Rule 10b-18 VWAP. The repurchase pricing

discrepancy between an eOMR and ASR may be attributable to the break right a public company retains under an eOMR and the potential for a lower effective purchase price in cases where the investment 'outperforms' under an eOMR.

Rule 10b-18 and Rule 10b5-1 Applied to eOMR

An eOMR is typically structured to benefit from the protections offered by a Rule 10b5-1 plan. If an eOMR is structured such that the share repurchase activity is executed on an agency or riskless principal basis, where shares are repurchased in the open market, then it may qualify for the Rule 10b-18 safe harbor.

CLOSING THOUGHTS

Like many things in life, share repurchase transactions may be simple or complex. Before executing any share repurchase transactions, a public company should undertake an analysis of various types of share repurchase alternatives and thoroughly understand the legal and commercial aspects of these types of transactions. Such analysis should include input from the relevant internal legal, tax, and accounting personnel and external advisors. ■