 Issuer Share Repurchase Safe Harbor

SEC Proposes to Clarify and Modernize Rule 10b-18

SUMMARY
The SEC has proposed amendments to Rule 10b-18, which provides issuers with a safe harbor from liability for manipulation when they repurchase their common stock in the market according to the Rule’s conditions. The Rule has four conditions, relating to manner of purchase, timing, purchase price and volume. The SEC proposes the following amendments to the Rule:

- The time of purchase condition, which currently requires that a Rule 10b-18 purchase not be the opening purchase for the security in the consolidated system, would be modified to require that it also not be the opening purchase in the principal market for the security or in the market where the purchase is effected;
- The price condition, which currently requires that a Rule 10b-18 purchase be made at a price no higher than the highest independent bid or the last independent sale price (whichever is higher), would be modified to permit a Rule 10b-18 purchase to be made on any trading day at a volume-weighted average price (“VWAP”) for the day, provided, among other things, that the security has an average daily trading volume (“ADTV”) of at least $1 million, the trade is entered into before the opening of the market, and the purchase does not exceed 10% of the ADTV for the security;
- Whereas failure to meet the conditions of the Rule with respect to any purchase on a given day currently disqualifies all the issuer’s purchases during that day, the Rule would be amended to provide that failure to comply with the pricing condition solely because of a “flickering quote” would disqualify only that purchase; and
- The merger exclusion, which generally bars reliance on the Rule following the announcement of a stock merger or similar transaction until the target shareholders have voted, would be extended with regard to a special purpose acquisition company (“SPAC”) until both the target shareholders and the SPAC shareholders have voted.

The SEC is seeking comment on the proposed changes and on an additional exception the SEC is considering but has not yet proposed, for purchases made using alternative passive pricing systems. The SEC has also asked for comments on a number of specific questions relating to the operation of Rule 10b-18. Comments are due on March 1, 2010.
BACKGROUND

The SEC adopted Rule 10b-18 in 1982, providing issuers a safe harbor from liability for manipulation under Section 9(a)(2) and 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Rule 10b-5 under the Exchange Act, when they repurchase their common stock in the market in accordance with the Rule’s manner, timing, price and volume conditions.1 Rule 10b-18 is not the exclusive means of making non-manipulative issuer repurchases, and the Rule states that there is no presumption that an issuer’s bids or purchases outside the safe harbor violate Sections 9(a)(2) or 10(b) or Rule 10b-5.

The SEC published the current proposal on January 29, 2010.2 The SEC believes that the Rule should be updated to better reflect the current operation of the market. Since the Rule was adopted in 1982, the SEC notes, there have been significant changes in trading strategies and the use of automated trading systems and other technology that have increased the speed of trading and changed the profile of how issuer repurchases are effected.

PROPOSALS

The SEC proposes to make four main changes to Rule 10b-18.

Time of Purchases. Currently, to qualify for the safe harbor, an issuer purchase may not be the opening regular-way purchase in the security reported in the consolidated system.3 However, the Rule does not exclude a purchase that is the opening purchase in the principal market for the security or the opening purchase in the market where the purchase is effected, provided there is already an opening purchase of the security reported in the consolidated system that day. According to the proposing release, the SEC is concerned that the opening transaction in the principal market for a security, and the opening transaction in the market where the issuer’s repurchase is effected, can in some cases be a more significant indicator of the direction of trading, the strength of demand and the current market value of the security than the opening transaction reported in the consolidated system that day. This is particularly so when, for example, a small number of an issuer’s shares prints as a regional exchange’s opening transaction in the consolidated system and then, immediately after, a substantially larger number of the issuer’s shares

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1 The safe harbor applies only with regard to liability for manipulation resulting from the time, price, amount or manner of purchase. It does not extend to liability for other matters, such as the failure to disclose material, non-public information in connection with a repurchase.

2 Release No. 34-61414 (January 25, 2010).

3 The safe harbor also does not apply to purchases effected during a specified period before the scheduled close of the primary trading session in the principal market for the security and in the market where the purchase is effected – 10 minutes before the scheduled close for a security that has an ADTV of $1 million or more and a public float value of $150 million or more, and 30 minutes before the scheduled close for all other securities. No change is proposed with respect to these periods.
prints in the consolidated system as the official opening transaction in the principal market for the issuer’s securities. This issue has become more prevalent due to the proliferation of alternative trading systems.

**Price of Purchases – VWAP Transactions.** An issuer may give its broker-dealer an order to buy a specified volume of shares at the volume-weighted average price (or VWAP price) for that day. Because VWAP is calculated based on the prices of trades executed throughout the day, the execution price of an issuer’s VWAP purchase effected at the end of the trading day, after calculation of the VWAP, may exceed the maximum price permitted under the Rule – i.e., the highest independent bid or the last independent transaction price quoted or reported in the consolidated system for the security when the purchase is effected (whichever is higher). In that event, the VWAP purchase will be outside the safe harbor’s current price condition.\(^4\)

The SEC proposes to except from the price condition of Rule 10b-18 purchases effected on a VWAP basis, provided the following criteria are met:

- The security that is subject to the VWAP purchase order qualifies as an actively traded security, as defined under Rule 101(c)(1) of Regulation M;
- The purchase is entered into or matched before the opening of the regular trading session;
- The execution price of the VWAP purchase is determined based on all regular way trades effected in accordance with the time and pricing conditions of the Rule that are reported in the consolidated system during the primary trading session for the security (i.e., excluding the opening trade, and trades executed during the last 10 or 30 minutes of trading, as applicable);
- The purchase does not exceed 10% of the ADTV\(^5\) for the security;\(^6\)
- The purchase is not effected for the purpose of creating actual or apparent active trading in or otherwise affecting the price of any security;
- The VWAP assigned to the purchase is calculated by (A) calculating the values, for every regular-way trade reported in the consolidated system during the regular trading session, excluding those not meeting the time and price conditions of the Rule, by multiplying each such price by the total number of shares traded at that price, (B) compiling an aggregate sum of all values, and (C) dividing the aggregate sum by the total number of trade-reported shares for that day in the security that represent

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\(^4\) Execution of VWAP orders can also result in the execution of orders at prices that are lower than a protected bid or higher than a protected offer. Such executions would violate the trade-through prohibition of Regulation NMS, Rule 611, but for the exception of Rule 611(b)(7), which applies to the execution of an order at a price that is not based, directly or indirectly, on the quoted price of the NMS stock at the time of execution, and for which the material terms were not reasonably determinable at the time the commitment to execute the order was made.

\(^5\) “ADTV” is defined in Rule 100(b) of Regulation M as the worldwide average daily trading volume during the two full calendar months immediately preceding, or any consecutive 60 calendar days ending with the 10 calendar days preceding the relevant measurement date, which for rule 10b-18 would be the date of purchase.

\(^6\) As currently proposed, this limitation would preclude reliance on the Rule for VWAP purchases in the full amount that would otherwise be permitted under the current 25% volume limitation on a given day.
regular-way trades effected in accordance with the time and price conditions of the Rule and reported in the consolidated system during the primary trading session for the security; and

- The purchase is reported using a special VWAP trade modifier (.W), in order to indicate to the market that the purchase is unrelated to the current or closing price of the security, and thus to prevent the VWAP purchase from providing any price discovery information or influencing the pricing direction of the security.\(^7\)

The SEC asks for comments on the proposed VWAP exception and possible modifications. For example, should a “full day” of trading be defined to permit VWAP purchases to be entered into or matched between 9:30 and 10:00 a.m. EST, rather than requiring the VWAP purchase to be entered into or matched before the regular trading session opens? Similarly, should the VWAP exception be permitted for purchases that are based on an intra-day VWAP of time intervals specified by the purchaser, such as the interval between 9:30 a.m. EST and 1:00 p.m. EST, rather than a full day’s trading volume?

Other Passive Pricing Systems. The SEC is also considering whether to propose an exception from the price condition for other passive pricing mechanisms. One such alternative, which has not been included in the text of the proposed amendment, would be based on exemptive relief provided under former Rule 10a-1. This exception would apply to purchases that are effected in an electronic trading system that matches buying and selling interest at various times throughout the day if, according to the SEC’s example, the following conditions are met:

- Matches occur at an externally derived price within the existing market and above the current national best bid;
- Sellers and purchasers are not assured of receiving a matching order;
- Sellers and purchasers do not know when a match will occur;
- Persons relying on the exception are not represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction;
- Transactions in the electronic trading system are not made for the purpose of creating actual, or apparent, active trading in, or depressing or otherwise manipulating the price of, any security;
- The covered security qualifies as an actively traded security (as defined in Rule 101(c)(1) of Regulation M); and
- During the period of time in which the electronic trading system may match buying and selling interest, there is no solicitation of customer orders, or any communication with customers that the match has not yet occurred.

Flickering Quotes. “Flickering quotes” occur when there are rapid changes in the current national best bid during the period between identification of the current national best bid and the execution or display of a Rule 10b-18 bid or purchase. In many active NMS stocks, the price of a trading center’s best displayed

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\(^7\) According to the SEC, this method of calculating VWAP is consistent with current industry practices for calculating VWAP. See the proposing release at text following note 61.

\(^8\) The SEC points out that the proposed criteria are similar to those specified by the Staff in providing VWAP exemptive relief from former Rule 10a-1 under the Exchange Act, the “up-tick” rule relating to short sales. See the proposing release at note 57.
quotation can change multiple times in a single second. A flickering quote could result in an issuer order being placed at a price that complies with the Rule 10b-18 price limit but then being executed at a price that exceeds the limit, due to no fault of the issuer or its broker. Under the general disqualification provision of the Rule, this would result in the loss of the safe harbor not only for the trade affected by the flickering quote, but for all of the issuer’s otherwise compliant purchases during the same trading day.

The SEC, recognizing that the increased speed of today’s markets has made it more difficult for an issuer to ensure that every purchase of its common stock during the day will meet the Rule’s current price condition, proposes to amend the Rule and Preliminary Note 1 to limit the disqualification provision in instances where an issuer’s repurchase order is entered in accordance with the Rule’s four conditions but is, immediately thereafter, executed outside the price condition solely due to flickering quotes. In these instances, only the non-compliant purchase, rather than all of the issuer’s other Rule 10b-18 purchases for that day, would be disqualified from the safe harbor.

The SEC asks whether this proposed exception from blanket disqualification should be narrowed so as to apply only to a specified volume of compliant purchases, such as those not exceeding 1%, 2% or 5% of ADTV for the relevant security. The SEC also asks whether the Rule should require that issuers use specific data management strategies to retain and recall order history to demonstrate compliance with the safe harbor’s price condition at the time of order entry.

The SEC does not explain why the proposed exception would not cover the otherwise compliant purchase rendered non-compliant solely by flickering quotes. If failure to satisfy the pricing condition is excusable because of the unintended effect of flickering quotes, it is not clear why the affected purchase itself should be disqualified, assuming it otherwise meets the conditions of the Rule.

Merger Exclusion and SPACs. To be eligible for the safe harbor, an issuer purchase must be a “Rule 10b-18 purchase.” As currently defined, this term excludes issuer purchases effected during certain corporate events, such as a stock-for-stock merger, because of the heightened incentive for an issuer to facilitate the corporate action by repurchasing its shares. Specifically, the term excludes purchases effected during the period from the time of public announcement of a merger, acquisition or similar transaction involving a recapitalization (unless the transaction consideration is only cash and there is no valuation period), until the earlier of the completion of such transaction or the completion of the vote by the target shareholders. This is known as the “merger exclusion.”

When a special purpose acquisition company (SPAC) seeks to acquire another company, which it generally must do within 18 to 24 months after formation, the SPAC shareholders typically are given the opportunity to vote to approve the acquisition (in addition to any right the target shareholders may have).

9 Rule 611 of Regulation NMS, the trade-through rule (see note 4 above), contains an exception for flickering quotes.
The SEC believes that, because of the incentives for SPAC management to complete the acquisition, management may attempt to repurchase the SPAC’s shares to reduce the possibility that the acquisition will be disapproved or to support or raise the market price of the SPAC’s shares. Therefore, the SEC proposes to amend the merger exclusion to provide that, in the case of an acquisition by a SPAC, the exclusion applies until the earlier of the completion of the acquisition transaction or the completion of the votes by both the target shareholders and the SPAC shareholders.

In its request for comments, the SEC asks whether, given the special nature of SPACs and the incentives for their managers, the Rule 10b-18 safe harbor should be unavailable to SPACs for any of their repurchases. A special provision for SPACs may be of limited application in any event given current market conditions for SPACs.
SULLIVAN & CROMWELL LLP

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