

ClientAlert

Capital Markets

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SEC Proposes to Modernize Safe Harbor for Issuer Repurchases

The Securities and Exchange Commission (the "SEC") last week proposed amendments to the Rule 10b-18 safe harbor for issuer stock repurchases.¹ Compliance with Rule 10b-18 offers protection from the antimanipulation provisions of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). As a result, most companies conducting share buyback programs seek to structure such programs to comply with Rule 10b-18. However, compliance has become more difficult as a result of new trading methodologies that fall outside the safe harbor even though such methodologies present little risk of market manipulation. Conversely, opening purchases in certain markets, together with repurchases during the pendency of SPAC transactions, currently fall within the safe harbor even though they present a risk of manipulation. The proposed amendments are intended to modernize Rule 10b-18 to address these issues.

If adopted as proposed, the amendments would primarily make the following changes:

- **Permit VWAP purchases.** The proposed amendments would expand the safe harbor to cover company repurchases using the now widely-accepted volume-weighted average price ("VWAP") methodology, subject to certain conditions intended to reduce the risk of market manipulation.
- **Further restrict opening purchases.** The proposed amendments would restrict companies from making the opening purchase in the stock's principal market and in the market in which the transaction is being effected, in addition to the current restriction on being the first purchase reported in the consolidated system.
- **Expand the safe harbor to accommodate "flickering quotes."** Under the proposed amendments, a company's noncompliance with the price condition of the rule solely due to "flickering quotes" would only disqualify the noncompliant purchase from the protection of the safe harbor and not all purchases for that trading day.
- **Expand the merger exclusion for SPACs.** The proposed amendments would exclude from the protection of the safe harbor all repurchases by special purpose acquisition companies ("SPACs") involved in an acquisition, when such repurchases were made prior to a vote of the SPAC shareholders.

The SEC is seeking public comment on the proposed amendments on or before March 1, 2010.



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¹ See "Purchases of Certain Equity Securities by the Issuer and Others," Release No. 34-61414 at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.

Proposed Rule Changes

We have listed below the current provisions of the rule that are proposed to be changed, together with the proposed change and a discussion of its impact.

Proposal to Permit VWAP Purchases	
Current Provision	Proposed Provision
<p>The purchase price may be no higher than the higher of (1) the highest independent bid or (2) the last independent transaction price quoted or reported in the consolidated system² at the time the purchase is effected.</p>	<p>Repurchases based on VWAP will be permitted, subject to the following conditions:</p> <ol style="list-style-type: none"> 1. The subject security must be “actively traded” (e.g., the security must have an average daily trading volume (ADTV) of at least US\$1 million and the issuer must have a common equity public float of at least US\$150 million). 2. The VWAP repurchase must be entered into or matched before the regular trading session opens. 3. The execution price must be determined based on the volume of the full trading day, but excluding trades that do not comply with the timing or pricing conditions of the safe harbor. This way the VWAP price would be based only on those trades an issuer could have made under the safe harbor conditions. 4. The volume repurchased may not exceed ten percent of the security’s ADTV. 5. The VWAP price must be calculated by: <ol style="list-style-type: none"> a. Adding the values of every regular way trade in the security reported in the consolidated system during that day’s regular trading session, except for trades excluded by the timing and pricing conditions; and b. Dividing the above sum by the number of shares traded that day during the primary trading session, as reported in the consolidated system, except for trades excluded by the timing and pricing conditions. 6. The repurchase may not be made for the purpose of creating actual or apparent active trading in any security or otherwise affecting the price of any security. 7. The purchase must be reported using a VWAP trading modifier to indicate that such purchases do not reflect the current or closing price of the security.
<p>Commentary. The current provision excludes from safe harbor protection purchases using passive or independently-derived pricing mechanisms, such as those based on VWAP or the midpoint of the national best bid offer (NBBO). This is because the VWAP price calculated at the end of the trading day or the NBBO may exceed the higher of the highest independent bid or last independent transaction price. The proposed amendments would extend safe harbor protection to purchases using VWAP. The conditions for the use of VWAP under the proposed rules are similar to those required by the SEC in the past when granting relief from the short sale rules for VWAP short sale transactions. The SEC believes that VWAP purchases in compliance with these conditions present little risk of market manipulation as the pricing is based upon independent market forces and is identified as such to all market participants. The SEC is seeking comment on whether repurchases based upon NBBO or other passive and independently-derived pricing mechanisms should also be covered by the safe harbor.</p>	

² The “consolidated system” is defined as “a consolidated transaction or quotation reporting system that collects and publicly disseminates on a current and continuous basis transaction or quotation information in common equity securities pursuant to an effective transaction reporting plan or an effective national market system plan.”

Proposal to Further Restrict Opening Purchases	
Current Provision	Proposed Provision
A company's repurchase may not be the opening regular way purchase reported in the consolidated system.	A company repurchase will only be within the safe harbor if it is made after the opening regular way purchases reported in the consolidated system and effected on both the principal market for the security and the market where the purchase is made.
<p>Commentary. There are instances where the first purchase reported in the consolidated system will not be from the principal trading market for the issuer's securities, but from a smaller exchange. In such instances, a subsequent larger opening purchase on the principal market for the security may have a greater impact on the direction of trading in the security and yet such purchase would be covered by the safe harbor. The timing condition of the safe harbor was designed to limit any effect an issuer purchase may have on the market value of the stock, so this result was clearly not what the SEC intended. The proposed amendment would close this loophole in the safe harbor for opening trades on markets that may most affect the trading of the security. The proposed change would also make the conditions governing the purchases at the start of trading consistent with the limitations currently placed on purchases prior to the close of trading.</p>	

Proposal to Expand the Safe Harbor to Accommodate "Flickering Quotes"	
Current Provision	Proposed Provision
A "flickering quote" occurs when there are rapid and repeated changes in the current national best bid during the period between identification of that bid and the execution of a repurchase under Rule 10b-18. This can result in the execution of a trade at a price that is above the highest independent bid, in violation of the Rule's pricing condition. Under Rule 10b-18's "disqualification provision" any violation of the manner, timing, price or volume conditions of the rule disqualifies a company's repurchases for the entire trading day from the safe harbor's protection.	The SEC is proposing to amend the Rule's disqualification provision for situations where a purchase is entered in compliance with the price condition, but at execution is not compliant, solely as a result of flickering quotes. In such an event, only the noncompliant purchase will be disqualified from the safe harbor. All other purchases during that trading day will still be covered by the safe harbor.
<p>Commentary. The current provision forces issuers undertaking repurchases during periods of heavy trading activity to use the last independent transaction price for such purchases or risk losing the safe harbor protection for all trades that day. The proposed amendment would provide issuers with flexibility to execute repurchases during periods of heavy trading activity using the highest independent bid with less risk of losing safe harbor protection for other purchases that day.</p>	

Proposal to Expand the Merger Exclusion for SPACs	
Current Provision	Proposed Provision
Repurchases made during the period from the public announcement of an acquisition until the earlier of (1) the completion of the transaction or (2) the completion of the vote by target shareholders, are not covered by the safe harbor.	The SEC is proposing to expand the merger exclusion to exclude SPAC repurchases until the earlier of the completion of the transaction or the completion of the vote by both target shareholders and SPAC shareholders.
<p>Commentary. Transactions involving SPACs have grown significantly in number and size over recent years. Acquisitions by SPACs must be approved by the SPAC's shareholders. In situations where the target company is private, this approval can occur long after the target shareholder vote is completed. The limited life of a SPAC—usually 24 months—places SPAC founders and managers under significant pressure to obtain approval of the SPAC's stockholders. In light of these pressures, a share repurchase program might assist the SPAC in achieving the requisite shareholder vote or raise the SPAC's share price thereby creating a more favorable impression of the proposed transaction. The proposed amendment is consistent with the objectives of the safe harbor, which is to limit potential manipulation by issuers undertaking a repurchase program. The effect of these rules may make it harder for SPACs to utilize share repurchases to obtain approval of proposed transactions.</p>	

Other Areas

The SEC is also seeking public comment regarding other aspects of the safe harbor, including:

- The application of the safe harbor to securities trading on the over-the-counter markets, such as the OTCBB and Pink Sheets, and any additional restrictions on repurchases of such securities that would help minimize market manipulation.
- The sufficiency of the safe harbor's volume condition or the thresholds necessary to satisfy that condition.
- The availability of the safe harbor for purchases using other passive and independently-derived pricing mechanisms, such as NBBO.
- The availability of the safe harbor when an issuer's insiders are selling the issuer's stock.
- The disclosures that should be required to be eligible for the safe harbor, including current financial information and specified information regarding the share repurchases and the timing of such disclosures.
- The maintenance of records evidencing compliance with the provisions of the safe harbor.
- The expansion of the safe harbor to cover other securities of the issuer, such as preferred stock, warrants, convertible debt securities, securities futures or option contracts or other securities.
- The application of the safe harbor to the purchases of an issuer's securities on foreign exchanges, the issuers that should be eligible for any such provision and the conditions applicable to such purchases.

Capital Markets

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