

# Securities Law Developments

 NEWSLETTER

NOVEMBER 21, 2003

## Issuer Repurchases: SEC Finalizes Amendments to the Safe Harbor and Imposes New Disclosure Requirements

On November 10, 2003, the Securities and Exchange Commission (“SEC” or “the Commission”) adopted amendments to Rule 10b-18 under the Securities Exchange Act of 1934 (“Exchange Act”) concerning issuer repurchases of its common stock, substantially as proposed in December 2002.<sup>1</sup> The SEC also adopted substantially as proposed new disclosure requirements applicable to all issuer repurchases of equity securities registered under Section 12 of the Exchange Act.

The effective date of the Rule 10b-18 amendments and the new disclosure requirements is December 17, 2003, except the technical amendments to Rule 23c-1(a)(11) (17 C.F.R. § 270.23c-1(a)(11)) and the elimination of Form N-23C-1 (17 C.F.R. § 274.201) under the Investment Company Act of 1940 will become effective on July 15,

2004. In addition, there are varying compliance dates for the new disclosure requirements, which are set forth in Section III.B.3. below.

### I. Introduction

Rule 10b-18 was first adopted in 1982.<sup>2</sup> It sets forth a non-exclusive safe harbor for issuers from liability for manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 under the Exchange Act, provided that the issuer’s repurchasing activity is conducted in accordance with the rule’s manner, timing, price, and volume conditions. Rule 10b-18’s safe harbor conditions are designed to minimize the market impact of the issuer’s repurchases, thereby allowing the stock price to reflect independent market forces without undue influence by the issuer.<sup>3</sup>

<sup>1</sup> *Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others*, Release Nos. 33-8160; 34-46980; IC-25845, 67 Fed. Reg. 77,594 (Dec. 18, 2002), available at <http://www.sec.gov/rules/proposed/33-8160.htm> (“Proposing Release”); *Purchases of Certain Equity Securities by the Issuer and Others*, Release Nos. 33-8335; 34-48766; IC-26252, 68 Fed. Reg. 64,952 (Nov. 17, 2003), available at <http://www.sec.gov/rules/final/33-8335.htm> (“Adopting Release”).

<sup>2</sup> *Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor*, Release Nos. 33-6434; 34-19244; IC-12823 (Nov. 17, 1982), 47 Fed. Reg. 53,333 (Nov. 26, 1982).

<sup>3</sup> *Id.*

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As discussed in the Adopting Release, various market developments since the rule's adoption 20 years ago have highlighted the need for updating and simplifying the rule's requirements. The revised rule will expand the safe harbor in two respects: (1) by allowing issuers whose securities are less susceptible to manipulation to stay in the market longer, and (2) by amending the "alternative conditions" for repurchasing activity following periods of severe market decline, thereby allowing issuers to repurchase a greater number of shares during such periods.

The new disclosure provisions in Regulation S-K, Regulation S-B, Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F and N-CSR seek to enhance the transparency of issuer repurchases. The new disclosures are independent of the safe harbor under Rule 10b-18.

## II. Rule 10b-18 Amendments

### A. Amendments to the Scope of the Rule

Currently, Rule 10b-18 only applies to bids for, and purchases of, an issuer's common stock by or for an issuer. Purchases of any other type of security are not covered even if the security is related to the common stock (*e.g.*, preferred stock, warrants, options, security futures, etc.). In addition, the safe harbor does not apply to certain corporate events that present an issuer with an increased incentive to manipulate the market price of its securities, such as mergers, tender offers, and distributions that involve the issuer.

#### 1. Eligible Securities

The revised rule merges the current definition of a "Rule 10b-18 bid" into the definition of

a "Rule 10b-18 purchase" so that a "Rule 10b-18 purchase" includes any "bid or limit order that would effect such purchase." The revised rule also clarifies that the safe harbor is available for repurchases of all common equity securities (*i.e.*, an issuer's common stock or an equivalent interest, including a unit of beneficial interest in a trust or limited partnership or a depository share).<sup>4</sup>

### 2. Availability of Rule 10b-18 Once a Merger, Acquisition or Similar Transaction Involving a Recapitalization is Announced

Currently, Rule 10b-18 excludes from the definition of a "Rule 10b-18 purchase" a purchase made "pursuant to a merger, acquisition, or similar transaction involving a recapitalization." In the Proposing Release, the SEC sought to "clarify" that this exclusion from the safe harbor would apply to all purchases effected "during the period from the time of public announcement of the merger, acquisition, or similar transaction, until the completion of such transaction." Many commenters argued against the proposed clarification, noting that Regulation M's restricted periods and other federal and state laws adequately address any manipulative concerns.

Taking such comments into consideration, the final amendments provide that the exclusion applies to purchases that are effected during the period from the time of public announcement<sup>5</sup> of a merger, acquisition, or similar transaction involving a recapitalization, "until the earlier of the completion of such transaction or the completion of the vote by target shareholders",<sup>6</sup> with the following exceptions:

<sup>4</sup> See Amended Rule 10b-18(a)(13).

<sup>5</sup> "Public announcement" is defined as any oral or written communication by any participant that is reasonably designed to, or has the effect of, informing the public or security holders in general about the business combination transaction. See 17 C.F.R. § 230.165(f).

<sup>6</sup> In general, the exclusion from the safe harbor will apply to purchases during any period where the market price of a security will be a factor in determining the consideration to be paid pursuant to a merger, acquisition, or similar transaction.

- The exclusion from the safe harbor does not extend to transactions in which the consideration is solely cash and there is no valuation period;
- The exclusion will allow ordinary Rule 10b-18 purchases to be effected after the announcement of a merger or covered transaction (subject to Regulation M’s restricted period and any other applicable restrictions), provided that the total amount of the issuer’s Rule 10b-18 purchases effected on any single day does not exceed the lesser of 25% of the security’s four-week average daily trading volume (“ADTV”) or the issuer’s average daily Rule 10b-18 purchases during the three full calendar months preceding the date of the announcement of the merger or other covered transaction;<sup>7</sup> and
- The issuer may effect block purchases in accordance with the rule’s new volume limitations (and subject to Regulation M’s restricted period and any other applicable restrictions), discussed below, provided that the issuer does not exceed the average size and frequency of block purchases effected pursuant to the rule during the three full calendar months preceding the date of the announcement of such transaction.<sup>8</sup>

### 3. Riskless Principal Transactions

The Proposing Release sought comment regarding the application of Rule 10b-18 to the two “legs” of a riskless principal transactions:

the broker-dealer’s purchase in the market for its own account and the issuer’s purchase of these shares from the broker-dealer. In the Adopting Release, the SEC stated its belief that the safe harbor should apply only to riskless principal trades that are analogous to agency trades effected on behalf of the issuer. That is, the safe harbor only should apply to those riskless principal transactions where both legs are effected at the same price and only one leg is reported to the market,<sup>9</sup> provided that the broker-dealer’s purchase meets all of the conditions of Rule 10b-18. Accordingly, the “Rule 10b-18 purchase” definition was amended to include a “riskless principal transaction,” as defined in the rule.<sup>10</sup>

#### B. Amendments to the Conditions of the Rule

By definition, Rule 10b-18 is intended to provide a safe harbor for issuer repurchases on a given day. To come within the safe harbor for that day, an issuer must satisfy the rule’s manner, timing, price, and volume conditions when purchasing its own common stock in the market. Failure to meet any one of the four conditions would mean that the issuer is unable to rely on the safe harbor for that day.

##### 1. Manner of Purchase

The Proposing Release did not seek to amend the existing requirement that an issuer use only a single broker or dealer per day to purchase its common stock. Indeed, the Adopting Release makes it clear that, while issuers can effect repurchases directly through an alternative trading system (“ATS”), they may not use both an ATS

<sup>7</sup> This latter calculation is different from the definition of ADTV set forth in Amended Rule 10b-18(a)(1).

<sup>8</sup> The parameters of the merger exclusion are set forth in Amended Rule 10b-18(a)(13)(iv).

<sup>9</sup> In general, these limitations are intended to track the relevant requirements under the National Association of Securities Dealers, Inc.’s (“NASD”) riskless principal trade-reporting rules. See NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6620(d)(3)(B).

<sup>10</sup> See Amended Rule 10b-18(a)(12). For purposes of this definition, a broker-dealer must have written policies and procedures in place to assure that, at a minimum, the issuer’s order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal account or the issuer’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.

directly and a non-ATS broker-dealer on any single day because such practices could create the perception of widespread demand.<sup>11</sup> The revised rule, however, clarifies that a non-ATS broker-dealer who accesses ATS liquidity on behalf of the issuer on that day will not violate the one broker or dealer condition.<sup>12</sup>

## 2. Timing of Purchase

The Proposing Release sought to revise the timing condition by using an ADTV value and public float value test (as defined in 17 C.F.R. § 242.100) to determine when an issuer must be out of the market before the scheduled close of trading in order to qualify for the safe harbor. As adopted, the revised rule provides that issuers of securities having an ADTV value of \$1 million or more and a public float value of \$150 million or more<sup>13</sup> may not purchase their securities in the ten minutes before the scheduled close of the primary (regular) trading session in either (1) the principal market for the security or (2) the market where the purchase is made. For all other eligible securities, issuers may not purchase their securities during the 30 minutes before the scheduled close of the primary (regular) trading session in either the principal market for the security or the market where the purchase is made.<sup>14</sup>

## 3. Price of Purchase

Currently, Rule 10b-18's price limitations vary, depending on the market for the security.<sup>15</sup> In order to simplify the rule, the SEC proposed and adopted a uniform price condition that limits all issuers to purchasing their securities at a price that does not exceed the highest independent bid or the last independent transaction price, whichever is higher, quoted or reported in the consolidated system. For securities that are not quoted or reported in the consolidated system, an issuer's repurchases must be effected at a price that does not exceed the highest independent bid or the last independent transaction price, whichever is higher, displayed and disseminated on any national securities exchange or on any inter-dealer quotation system (as defined in Exchange Act Rule 15c2-11) that displays at least two independent priced quotations for the security.<sup>16</sup> For all other securities, Rule 10b-18 purchases must be effected at a price no higher than the highest independent bid obtained from three independent dealers.<sup>17</sup>

## 4. Volume of Purchase

Citing its belief that market conditions no longer appear to justify excluding block purchases from the volume limitation, the SEC proposed to eliminate the special treatment of block purchases from the rule in the Proposing Release. Thus,

11 An issuer may, however, use a different broker or dealer for its after-hours Rule 10b-18 purchases than the one used during normal trading hours. *See infra* Section II.C.1.

12 *See* Amended Rule 10b-18(b)(1)(iii).

13 In calculating the dollar value of the ADTV, any reasonable and verifiable method may be used. For example, it may be derived from multiplying each day's total volume of shares by the closing price on that day. As set forth in 17 C.F.R. § 242.100, public float value (*i.e.*, the aggregate market value of common equity securities held by non-affiliates of the issuer) is to be determined in the manner set forth on the front page of Form 10-K, even if the issuer of such securities is not required to file Form 10-K. For reporting issuers, the public float value should be taken from the issuer's most recent Form 10-K or based upon more recent information made available by the issuer.

14 *See* Amended Rule 10b-18(b)(2). The amended rule continues to preclude an issuer from effecting a Rule 10b-18 purchase as the opening transaction for the day.

15 *See* Rule 10b-18(b)(3).

16 Such securities would include, for example, Nasdaq SmallCap securities.

17 *See* Amended Rule 10b-18(b)(3).

under the proposed amendments, an issuer's Rule 10b-18 purchases, on any single day, could not have exceeded the higher of 25% of the ADTV for that security, including block purchases made by or on behalf of the issuer, or a daily aggregate amount of 500 shares.

The public commenters uniformly objected to the proposed elimination of the block exception based on concerns that the proposal would significantly limit, in particular, the repurchasing activity of issuers of thinly-traded securities. In response, the Commission decided to retain the block exception, but on a severely curtailed basis. Under the amended rule, issuers may make (within the safe harbor) one block purchase per week, provided there are no other Rule 10b-18 purchases on that day. Thus, once each week, an issuer may purchase one block of its common stock in lieu of purchasing under the 25% volume limitation for that day. However, shares purchased by the issuer relying on this amended block exception may not be included when calculating a security's four-week ADTV under the rule.<sup>18</sup>

## C. Other Amendments

### 1. After-Hours Trading

While the SEC did not propose specific amendments regarding the applicability of Rule 10b-18 to purchases effected after the close of the primary trading session ("after-hours"), it did seek comment on the issue. After considering the public comments, the SEC decided to extend the safe harbor to issuer repurchases effected after-hours (while the consolidated system is still open), as long as they are effected at prices that do not exceed the lower of the closing price of the primary trading session in the principal market for the security and any lower bids or sale prices subsequently reported in

the consolidated system by other markets. The repurchases would still need to comply with the other three conditions of the safe harbor, with the following modifications:

- The issuer may use a different broker or dealer for its after-hours Rule 10b-18 repurchases than the one used during normal trading hours;
- The issuer may not effect a Rule 10b-18 purchase as the opening transaction of the after-hours trading session, but may continue to repurchase until the termination of the period in which last sale prices are reported in the consolidated system; and
- The rule's volume calculation will carry over from the regular trading session.<sup>19</sup>

### 2. Alternative Conditions

On September 23, 1999, the SEC implemented "alternative conditions" for Rule 10b-18, which go into effect following the imposition of a market-wide trading suspension. When the alternative conditions are triggered, issuer repurchases under the safe harbor can be made at the market reopening until the close of trading that day or, if the suspension is still in effect at the close, at the next day's opening until the scheduled close of trading.<sup>20</sup> In light of the extreme market volatility that would trigger a market-wide trading suspension and the resultant need for facilitating liquidity, the SEC proposed and adopted expanding the safe harbor's alternative conditions by increasing the volume limitations. Thus, issuer repurchases made when the alternative conditions are in effect are subject to a volume limitation of 100%, rather than the current 25%, of the ADTV for that security.<sup>21</sup>

18 See Amended Rule 10b-18(b)(4). For purposes of the amended block exception, the SEC retained the current "block" definition in Rule 10b-18(a)(5).

19 See Amended Rule 10b-18(b)(2)(iv).

20 *Purchases of Certain Equity Securities by the Issuer and Others*, Exchange Act Release No. 34-41905 (Sept. 23, 1999), 64 Fed. Reg. 52,428 (Sept. 29, 1999), available at [www.sec.gov/rules/final/34-41905.htm](http://www.sec.gov/rules/final/34-41905.htm).

21 See Amended Rule 10b-18(c)(2).

### III. New Disclosure Requirements for Issuer Repurchases of Equity Securities

To provide investors with information about the level, frequency and purpose of issuer repurchases, the SEC adopted new rules requiring issuers to disclose in their periodic reports certain information regarding issuer repurchases of equity securities regardless of whether those purchases occur in the open market, privately or pursuant to the Rule 10b-18 safe harbor and regardless of whether the purchases occur inside or outside the United States.<sup>22</sup> For domestic issuers, these disclosures must be included in the issuer's reports on Forms 10-Q or 10-QSB and Form 10-K or 10-KSB. Foreign private issuers must include the required disclosures in their annual reports on Form 20-F, and closed-end funds must include the disclosures semi-annually on Form N-CSR.

#### A. Summary of New Issuer Repurchase Disclosure

Pursuant to new Item 703 of Regulation S-K and Regulation S-B, issuers must present a table captioned "Issuer Purchases of Equity Securities"<sup>23</sup> quantifying on a monthly basis the following information with respect to any class of the issuer's equity securities that is registered under Section 12 of the Exchange Act:<sup>24</sup>

- the total number of shares or units purchased,
- the average price paid per share,

- the total number of shares or units purchased as part of a publicly announced repurchase plan or program, and
- the maximum number or approximate dollar value of shares or units that may yet be purchased under the plan or program.

Issuers must also include footnotes to the table that briefly disclose the principal terms of any publicly announced repurchase plan or program, including:

- the date of the announcement,
- the share or dollar amount approved,
- the expiration date (if any) of the plan or program,
- each plan or program that has expired during the period covered by the table, and
- each plan or program that the issuer has determined to terminate prior to expiration or under which the issuer does not intend to make further purchases.<sup>25</sup>

The footnotes to the table must also identify the number of shares purchased by the issuer other than through a publicly announced plan or program and the nature of any such transactions, specifically whether the purchases were made in open-market transactions, in tender offers, in satisfaction of the company's obligations upon exercise of outstanding put options, or in other transactions.<sup>26</sup>

22 See new Item 703 of Regulation S-K and Instruction to new Item 703; new Item 703 of Regulation S-B and Instruction to new Item 703.

23 See Item 703(a) of Regulation S-K; Item 703(a) of Regulation S-B. The tables in Forms 10-Q, 10-QSB, 10-K and 10-KSB must present this information on a monthly basis for each of the months covered by the form (the last three months of the period with respect to Forms 10-K and 10-KSB). Similarly, Form 20-F and Form N-CSR must disclose the tabular information (on a monthly and cumulative basis) for the entire year and sixth month period, respectively.

24 See Item 703(a) of Regulation S-K; Item 703(a) of Regulation S-B. The new disclosure is required regardless of whether the equity security is listed on a national securities exchange or quoted on an inter-dealer quotation system.

25 See Instruction 2 to Item 703(b)(3) and (b)(4) of Regulation S-K; Instruction 2 to Item 703(b)(3) and (b)(4) of Regulation S-B; Instruction 2 to Item 16E(b)(3) and (4) of amended Form 20-F; and Instruction 2 to Item 8(b)(3) and (4) of amended Form N-CSR.

26 See Instruction to paragraph (b)(1) of Item 703 of Regulation S-K; Instruction to paragraph (b)(1) of Item 703 of Regulation S-B.

Issuers will need to establish appropriate mechanisms to track and collect on a monthly basis price, volume and other repurchase activity as required by the table and footnotes.

## **B. Modifications from Proposed Rules and Compliance Dates**

### **1. SEC Declines to Force Identification of Broker-Dealers**

The SEC proposed that issuers disclose the identity of broker-dealers who effect issuer repurchases. Commenters characterized the proposed broker-dealer identification as unnecessary disclosure of confidential business information that could provide an informational advantage to other market participants. In response to these concerns, the SEC eliminated broker-dealer identification from the adopted rules and forms. The SEC assured issuers in footnote 101 to the Adopting Release that, although the SEC can request the identity of the broker-dealer under a variety of circumstances, this information would not be made public.

### **2. Disclosure of Intent to Purchase Is Not Required but Decision *Not* to Purchase Must be Disclosed**

The SEC's proposal would have mandated disclosure of whether the issuer intends to purchase under a plan or program under which the issuer has not purchased during the period covered by the table. Commenters objected to this proposal and expressed concerns that forward-looking statements about potential purchases could mislead investors. As a result, the SEC did not include this requirement in the adopted provisions. Instead, as indicated in Section III.A. above, disclosure is required if the issuer has determined to stop making purchases under a plan or program.

## **3. Compliance Dates for the New Disclosure**

Issuers filing reports on Forms 10-Q or 10-QSB and Form 10-K or 10-KSB must include the new table in reports for periods ending on or after March 15, 2004. For calendar year companies, this means that the new disclosures must appear in the Form 10-Q for the first quarter of 2004. Foreign private issuers have an additional nine months compared to domestic issuers; Form 20-F must include the new disclosure for periods ending on or after December 15, 2004. Registered closed-end funds must include the table in Forms N-CSR for periods ending on or after June 15, 2004.

### **C. New Disclosure Rules Do Not Extend to Anti-Fraud Provisions**

Compliance with the new disclosures will not excuse an issuer from disclosure obligations arising under other provisions of the federal securities laws, including Rules 10b-5 and 12b-20 of the Exchange Act.<sup>27</sup> With respect to Rule 10b-5, the Proposing and Adopting Releases both present a hypothetical of an issuer announcing a repurchase program with no intention of making purchases. The Commission noted that the issuer "may violate the anti-fraud and anti-manipulation provisions of the federal securities laws." Issuers also need to consider whether they are aware of material non-public information at the time they decide to implement a stock repurchase plan.<sup>28</sup>

\* \* \*

27 See Adopting Release at footnote 103, 68 Fed. Reg. at 64,962.

28 In this regard, Rule 10b5-1 is available to issuers for repurchases of their stock.

If you would like a copy of the Adopting Release, or if you have any questions regarding Part II, the Rule 10b-18 amendments, please contact

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