

SEC AMENDS ISSUER COMMON STOCK REPURCHASE SAFE HARBOR

DECEMBER 19, 2003

Introduction

On November 10, 2003, the Securities and Exchange Commission adopted amendments to Rule 10b-18, which provides a limited safe harbor from claims of market manipulation in the context of issuers repurchasing their own common stock.¹ The Rule generally provides that an issuer will not be deemed to have engaged in a deceptive trading practice in violation of Section 9(a)(2) and 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5 solely by virtue of its trading activity if the issuer's repurchases are made in conformity with the Rule. The amendments to Rule 10b-18, which became effective on December 17, 2003, are designed, according to the SEC "to simplify and update the safe harbor provisions in light of market developments since the Rule's adoption" in 1982.

In connection with the amendments to Rule 10b-18, the SEC has also adopted amendments to a number of periodic report forms and to Regulation S-K in order to require regular disclosure of issuer repurchases of equity securities registered under Section 12 of the Exchange Act, regardless of whether the repurchases are effected in accordance with Rule 10b-18. For most domestic issuers, this additional disclosure will need to appear in reports filed on Form 10-K and 10-Q for periods ending on or after March 15, 2004. For foreign private issuers this disclosure will need to appear in reports on Form 20-F filed for fiscal years ending on or after December 15, 2004. Finally, for registered closed-end funds this disclosure will need to appear in reports on Form N-CSR filed for periods ending on or after June 15, 2004.

Overview

The recently adopted amendments contain a variety of substantive as well as technical changes. For most issuers, the five most relevant substantive changes:

- limit the availability of the Rule 10b-18 safe harbor for issuers involved in mergers, acquisitions or other forms of recapitalizations - the so-called "merger exclusion";
- subject block trades to the volume limitations of Rule 10b-18;
- lengthen the amount of time during the trading day that issuers of actively traded securities can effect repurchases within the safe harbor;

¹ The safe harbor also extends to repurchases by affiliated purchasers of an issuer.

- establish a uniform price limitation for repurchases made in conformity with the safe harbor; and
- require increased disclosure by issuers repurchasing their equity securities.

These changes are discussed in the first part of this memo under the heading “Substantive Changes to Rule 10b-18.” The more technical modifications to the Rule are discussed in the second part of this memo under the heading “Technical Amendments and Clarifications.”

SUBSTANTIVE CHANGES TO RULE 10b-18

Limiting the Availability of Rule 10b-18 once a Merger, Acquisition or Similar Transaction Involving a Recapitalization is Announced

One of the most significant changes effected by the amendments relates to the so-called “merger exclusion” to Rule 10b-18. This exclusion states that the Rule 10b-18 safe harbor is not available for repurchases made “pursuant to a merger, acquisition or similar transaction involving a recapitalization.” Prior to adoption of the amendments to the Rule, it was widely believed that this exclusion meant that an issuer could not rely on the safe harbor in *effecting* the merger, acquisition or recapitalization (i.e. purchases made as part of the covered transaction were not eligible for protection under Rule 10b-18) but that any other purchases made while the transaction was pending could qualify. Therefore, an acquiror in a stock for stock acquisition could (subject to the limitations of Regulation M and taking into account the prohibitions of Rule 10b-5) repurchase its common stock in the open market after announcing the acquisition to help partially offset any downward pressure placed on its stock after the announcement.

The newly enacted amendments to Rule 10b-18 “clarify” that all stock repurchases made from the time of the “public announcement” of a merger, acquisition or similar transaction involving a recapitalization (whether or not made as part of the covered transaction) until the earlier of (1) the completion of such transaction or (2) the completion of the vote by the target shareholders (including during any period where the market price of a security will be a factor in determining the consideration to be paid pursuant to the transaction) will, subject to a few newly-created exceptions described below, fall outside the Rule 10b-18 safe harbor.

In order to address concerns raised by numerous commentators over the perceived expansion by the SEC of the merger exclusion, the SEC added several limited exceptions to the merger exclusion that will enable issuers to still avail themselves of the safe harbor, even if the repurchases were occurring between the announcement and completion of a merger or acquisition. These exceptions allow repurchases to still qualify for the safe harbor:

- during a transaction in which the consideration offered is solely cash and there is no valuation period;

- for purchases during the post-announcement period so long as the total amount of the issuer's Rule 10b-18 purchases on any single day does not exceed the lesser of (i) 25% of the security's four-week average daily trading volume ("ADTV") or (ii) the issuer's average daily Rule 10b-18 purchases during the three full calendar months preceding the date of the announcement of the transaction. If an issuer did not make any Rule 10b-18 purchases during the preceding three-month period it would not be able to make any Rule 10b-18 purchases during the post-announcement period;
- for block purchases made under the newly created block trade exception to Rule 10b-18.²

The expansion of the merger exclusion has a number of consequences for companies who are seeking to implement stock buyback programs and who might wish to use their common stock as acquisition currency. These consequences include:

- **Restrictions begin at the time of the public announcement of the deal.** Unlike the timing restrictions imposed by Regulation M (which take effect on the day the proxy solicitation or offering materials are first disseminated to security holders), an issuer can lose the protection afforded by Rule 10b-18 upon the "public announcement" of the transaction. Under the Rule, a "public announcement" is "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." Accordingly, even in situations where one of the parties has only announced an intention to pursue a possible transaction or the parties have issued a press release in response to a leak regarding the transaction or a stock exchange inquiry, it would effectively bring any open market purchases undertaken by either party within the limitations of the merger exclusion. This change represents a significant extension of the applicable restricted period beyond the limitations imposed by Regulation M for issuers who are unwilling to effect their stock repurchases outside of the Rule 10b-18 safe harbor and who don't qualify under one of the exceptions to the merger exclusion outlined above.
- **The merger exclusion applies regardless of the size or significance of the possible acquisition.** In enacting the amendments, the SEC explicitly refused to exclude *de minimis* or immaterial transactions from triggering the merger exclusion. Accordingly,

² The amendments add a new block trade exception to the Rule, which allows an issuer once each week, in lieu of making any other Rule 10b-18 purchases on that day, to make one block purchase of any size. The block trade exception is applicable in the context of the merger exclusion only where the issuer does not exceed the average size and frequency of block purchases effected relying on the block trade exception during the three full calendar months preceding the date of the announcement of the transaction. If an issuer did not make any block purchases in reliance on the block trade exception during the preceding three-month period (e.g. the issuer made multiple purchases in reliance on Rule 10b-18 on each of the days in which it was in the market repurchasing its common stock) it would not be able to use this exception during the post-announcement period.

any merger, acquisition or similar transaction, regardless of its size, will trigger the application of the merger exclusion unless the consideration is all cash and there is no valuation period or one of the other exceptions is available. The absence of any *de minimis* exception may prove particularly troublesome for active acquirors with multiple overlapping small transactions, presenting the possibility that such companies may be unable to repurchase their common stock in reliance upon the 10b-18 safe harbor for extended periods of time.

- **10b-5 concerns leading up to the announcement of an acquisition may significantly limit an issuer’s ability to utilize the exceptions to the merger exclusion.** As discussed above, one of the exceptions to the merger exclusion states that issuers may make 10b-18 repurchases following the announcement of an acquisition if these repurchases do not exceed the lesser of (i) 25% of the security’s four-week ADTV or (ii) the issuer’s average daily Rule 10b-18 purchases during the three full calendar months preceding the date of the announcement of the transaction. As a result of 10b-5 concerns, most companies will suspend their share repurchase programs while they are negotiating a material transaction. Since these negotiations can go on for an extended period of time, issuers may well find that their average daily Rule 10b-18 purchases in the three-months preceding the announcement are very small or non-existent. Accordingly, this exception to the merger exclusion may be of limited applicability.
- **The new formulation of the merger exclusion limits both acquiror and target from repurchasing their common stock.** Prior to these amendments to Rule 10b-18, the merger exclusion was thought to only limit the acquiror since it was only designed to prevent companies from relying on the safe harbor in effecting the merger or acquisition. In its expanded form, however, the merger exclusion appears to apply to both the acquiror and the target company. Accordingly, both the target and the acquiror will need to limit purchases of their own common stock during the course of the merger or acquisition.³
- **Issuers may need to interpret the meaning of “acquisition” and “recapitalization” broadly.** The merger exclusion applies to a “merger, acquisition or similar transaction involving a recapitalization.” The SEC has not defined “acquisition” or “recapitalization” in the amendments to Rule 10b-18 but appears to be inclined to interpret these terms expansively, based on statements included in the SEC’s promulgating release. Accordingly, until there is greater clarity, issuers may themselves need to take a similarly broad view of what might constitute an “acquisition” or a “recapitalization.” For example, an acquiror using its common stock to purchase assets

³ In this regard, the new formulation of Rule 10b-18 differs from the limitations imposed by Regulation M which limits repurchases during the restricted period of the stock in distribution, namely the stock of the acquirer in most instances. Regulation M does not generally restrict the ability of the target to continue its stock repurchase program during the restricted period.

from a target would most likely be deemed to be engaged in an acquisition for purposes of this exclusion. Similarly, an issuer using shares of its common stock as partial consideration in connection with the formation of a joint venture could conceivably trigger the merger exclusion depending on the structure of the transaction.

- **Other limitations still apply.** Regardless of whether a stock repurchase undertaken during an acquisition transaction can be structured in such a way as to comply with the requirements of Rule 10b-18, issuers must keep in mind that any repurchases are still subject to Regulation M's restricted period and any other applicable restrictions. This would also include the limitation imposed by Rule 14e-5 under the Exchange Act which prohibits purchases or arrangements to purchase securities that are the subject of an exchange offer, or a security immediately convertible into or exchangeable for those securities, from the time of public announcement of the exchange offer until its expiration.

Subjecting Block Trades to the Volume Limitations of Rule 10b-18

Rule 10b-18's volume condition limits the amount of securities an issuer may repurchase in the market in any single day. Prior to the amendments to Rule 10b-18, an issuer could effect daily purchases in an amount up to 25% of the average daily trading volume (ADTV) in its shares for the four calendar weeks preceding the week in which the 10b-18 purchase takes place and this 25% volume limitation did not include an issuer's block purchases.⁴ Consequently, prior to the effectiveness of the amendments to Rule 10b-18, block purchases were not subject to the volume condition and such purchases could be effected on an unlimited basis. In addition, prior to the amendments, the shares purchased by an issuer in block transactions were not included when calculating the four-week ADTV.

In the promulgating release for the 10b-18 amendments, the SEC noted that block transactions currently represent one-half of all issuer repurchase activity and that it believes that exempting block trades created the "potential for manipulative abuse." In order to prevent this possible abuse, the amendments have revised the volume condition to provide that the

⁴ The amendments retain the prior definition of a "block", which stated that a block is a quantity of stock that either: (i) has a purchase price of \$200,000 or more; or (ii) is at least 5,000 shares and has a purchase price of at least \$50,000; or (iii) is at least 20 round lots of the security and totals 150 percent or more of the trading volume for that security or, in the event that trading volume data are unavailable, is at least 20 round lots of the security and totals at least one-tenth of one percent (.001) of the outstanding shares of the security, exclusive of any shares owned by any affiliates; provided, however, that a block shall not include any amount a broker or dealer, acting as principal, has accumulated for the purpose of sale or resale to the issuer or to any affiliated purchaser of the issuer if the issuer or such affiliated purchaser knows or has reason to know that such amount was accumulated for such purpose, nor shall it include any amount that a broker or dealer has sold short to the issuer or to any affiliated purchaser of the issuer if the issuer or such affiliated purchaser knows or has reason to know that the sale was a short sale.

number of shares of common stock purchased on any single day in reliance upon the Rule 10b-18 safe harbor, *including* shares purchased in block trades, cannot exceed 25% of the ADTV of the common stock over the past four-weeks. Issuers, however, can include block purchases when calculating its stock's four-week ADTV in most circumstances. To address concerns of commentators that eliminating the block exception would negatively affect issuers with low or moderate ADTV's, the amendments create a new "block exception" which allows issuers to make one block purchase per week under the safe harbor, provided that the issuer does not make any other Rule 10b-18 purchases on that day and provided that such repurchase is not included in calculating the common stock's ADTV.

Lengthening the Period during the Trading Day that Issuers of Actively Traded Securities can Effect Repurchases

Prior to the amendments, the Rule 10b-18 safe harbor was unavailable for purchases by an issuer during the 30 minutes immediately prior the scheduled close of trading. In recognition of the fact that this time period may be unnecessarily long to prevent issuers of highly liquid securities from influencing the market near the close of trading, the amendments lengthen the period during which repurchases may be made by issuers of highly liquid common stock. The amendments have revised Rule 10b-18 to provide that issuers of more liquid securities⁵ may bid for or purchase their securities up until the last ten minutes before the scheduled close of the primary trading session in the principal market for the security. The applicable cut-off time for issuers of all other securities has not been modified by the amendments and remains at 30 minutes before the scheduled close. In adopting the amendments, the SEC considered, and rejected, a proposal to allow issuers of highly liquid securities to place the opening trade. Accordingly, as was the case prior to the amendments, issuers cannot qualify for the safe harbor in making the opening (regular way) purchase reported in the consolidated system.

Imposing a Uniform Price Condition for Repurchases

Prior to the amendments, the price limitations under Rule 10b-18 varied depending on the market for the security (i.e. whether the security was a "reported," "exchange-traded," "Nasdaq," or "other security"). The amendments do away with these distinctions and instead impose 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. If a security is not quoted or reported in the consolidated system, the price cannot exceed the highest independent bid or

⁵ Securities are eligible for the extended repurchase period if they have an ADTV value for the four calendar weeks preceding the week of the trade of \$1 million or more and a public float (defined as the aggregate market value of the voting and non-voting common equity held by nonaffiliates) of \$150 million or more.

the last independent transaction price, whichever is higher, that is displayed or disseminated on any national securities exchange or on any inter-dealer quotation system that displays at least two independent priced quotations for the security, at the time the Rule 10b-18 purchase is effected. For all other securities, the price cannot exceed the highest independent bid obtained from three independent dealers.

Requiring Increased Disclosure of Equity Securities Repurchases

Forms 10-Q, 10-QSB, 10-K, 10-KSB, 20-F (for foreign private issuers) and N-CSR (for closed-end funds) and Regulation S-K have been amended to require periodic disclosure of all repurchases by an issuer or any affiliated purchaser⁶ of equity securities that are registered by the issuer pursuant to Section 12 of the Exchange Act, regardless of whether the purchases were made in conformity with the Rule 10b-18 safe harbor.

Issuers will be required to disclose in a tabular format the following information for each class or series of securities for each month included in the period covered by the report⁷: (a) the total number of shares (or units) purchased, (b) the average price paid per share (or unit), (c) the total number of shares (or units) purchased as part of publicly announced plans or programs and (d) the maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under plans or programs.

Additionally, issuers must disclose the following information in footnotes to the tabular presentations: (a) the date each repurchase plan or program was announced, (b) the dollar amount (or share or unit amount) approved, (c) the expiration date (if any) of each plan or program, (d) each plan or program that has expired during the period covered by the table, and (e) each plan or program the issuer has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases. An issuer must also disclose in a footnote to the table the number of shares purchased other than through a publicly announced plan or program and the nature of the transaction (*e.g.*, whether the purchases were made in open-market or privately negotiated transactions, issuer tender offers, in satisfaction of the company's obligations upon exercise of outstanding put options issued by the company or other transactions through which the company purchases its Section 12 registered equity securities).

⁶ Any "affiliated purchaser" is defined by Rule 10b-18(a)(3) to include, among others, any person acting in concert with the issuer or an affiliate who controls the issuer's repurchases or whose purchases are controlled by the issuer. It explicitly does not include an officer or director of the issuer solely by reason of that officer or director's participation in the decision to authorize the issuer's 10b-18 repurchases.

⁷ Forms 10-K/10-KSB, 10Q/10-QSB and N-CSR require disclosure of all issuer repurchases for its last fiscal quarter or in the case of closed-end funds, semi-annual period. Form 20-F requires the disclosure on a yearly basis. The disclosure in Form 20-F regarding price data and other data should be stated in the same currency used in the issuer's primary financial statements.

The disclosure required in Forms 10-Q, 10-QSB, 10-K and 10KSB must appear in reports filed for periods ending on or after March 15, 2004. The disclosure required in Form 20-F must appear in Form 20-F reports filed for fiscal years ending on or after December 15, 2004. The disclosure required in Form N-CSR must appear in reports filed for periods ending on or after June 15, 2004. The SEC is eliminating the requirement for closed-end funds to disclose information regarding privately negotiated repurchases of their securities on Form N-23C-1 since it would be duplicative with the new disclosure. A closed-end fund need not file reports on Form N-23C-1 with respect to any repurchases during any calendar month following June 2004.

TECHNICAL AMENDMENTS AND CLARIFICATIONS

Preliminary Notes to Rule 10b-18

The amendments introduce two preliminary notes to Rule 10b-18. The first note states that, as a safe harbor, compliance with Rule 10b-18 is voluntary. However, in order to satisfy the requirements of the safe harbor, an issuer's repurchases must satisfy (on a daily basis) each of the Rule's four conditions (*i.e.*, one broker or dealer, time of purchase, price of purchase and volume of purchase). Failure to meet any one of these four conditions removes all of the issuer's repurchases from the safe harbor for that day. Further, the safe harbor is not available for repurchases that, although made in technical compliance with the Rule, are part of a plan or scheme to evade the federal securities laws. The second note states that regardless of whether repurchases are effected in accordance with Rule 10b-18, reporting issuers must comply with the new disclosure requirements regarding repurchases of equity securities.

Securities Covered by the 10b-18 Safe Harbor

The amendments clarify that Rule 10b-18 is available for purchases of all common equity securities of an issuer including "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". The promulgating release, however, reiterates the SEC's position that purchases of any other type of security are not eligible for the safe harbor of Rule 10b-18, even if related to the common stock. Therefore, purchases of preferred stock, warrants, rights, convertible debt securities, options or security futures products, including purchases using forward contracts or accelerated share repurchase programs, do not qualify for the safe harbor under the Rule.

Repurchases Effected in Markets Outside the United States

The safe harbor has historically applied only to issuer repurchases effected in markets in the United States. In connection with the amendment process, the SEC considered amending Rule 10b-18 to create a safe harbor for repurchases made in non-U.S. markets, but ultimately the SEC determined to continue to confine the safe harbor to issuer repurchases effected in markets in the United States.

Manner of Rule 10b-18 Purchases

Rule 10b-18 requires all purchases under the safe harbor to be effected through only one broker or dealer on any single day. The amendments clarify that issuers can also effect repurchases through an electronic communications network (“ECN”) or other alternate trading systems (“ATS”). Issuers, however, cannot use both an ECN or other ATS directly and a non-ECN or other non-ATS broker-dealer on any single day. Additionally, Rule 10b-18 has been amended to provide that if an issuer chooses to use a non-ECN or other non-ATS broker-dealer to conduct all of its repurchases on a particular day, that broker-dealer can access an ECN or other ATS on behalf of the issuer on that day.

Riskless Principal Transactions

The definition of “Rule 10b-18 purchase” has been amended to clarify how purchases undertaken by a broker or dealer on behalf of an issuer can qualify under the safe harbor. This was done in order to address concerns whether both “legs” of these transactions (namely the broker-dealer’s purchase in the market for its own account and the issuer’s purchase of the shares from the broker-dealer) could qualify. The amendments make it clear that both legs can qualify for the safe harbor so long as the trade qualifies as a “riskless principal transaction” in which:

- a broker or dealer after having received an order from an issuer to buy its security, buys the security as principal in the market at the same price to satisfy the issuer’s buy order;
- the issuer's purchase is effected at the same price per-share at which the broker or dealer bought the shares to satisfy the issuer's buy order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee; and
- only the first part of the transaction (the purchase by the broker or dealer in the market as principal) rather than the second part of the transaction (the sale of the shares by the broker or dealer to the issuer) is reported under the rules of a self-regulatory organization or under the Exchange Act;

In addition to qualify as a “riskless principal transaction”:

- the broker or dealer must have written policies and procedures in place to assure that, at a minimum, the issuer's buy 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 or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders effected on a riskless principal basis.

Applicability of the Safe Harbor during After-Hours Trading Sessions

The amendments extend the safe harbor to issuer repurchases during after-hours trading. Under the amendments, Rule 10b-18 purchases may be effected after the close of the primary trading session until the termination of the period in which last sale prices are reported in the consolidated system so long as:

- the purchases 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;
- the issuer complies with the other conditions of the safe harbor (price, volume and the use of only one broker or dealer; provided, however, that the one broker or dealer the issuer uses for after hours trading may be different from the broker or dealer that the issuer used during the primary trading session). The volume calculation would carry over from the regular trading session; and
- the issuer's purchase is not the opening transaction of the session following the close of the primary trading session.

Rule 10b-18 Alternative Conditions

Rule 10b-18 has been amended to allow issuers to purchase more of their securities within the safe harbor during the trading session following the termination of a market-wide trading suspension. A market-wide trading suspension is defined as a market-wide trading halt of 30 minutes or more that is: (i) imposed pursuant to the rules of a national securities exchange or a national securities association in response to a market-wide decline during a single trading session; or (ii) declared by the SEC pursuant to its authority under Sections 12(k) or 36 of the Exchange Act. In the event that a market-wide trading suspension occurs, the 25% ADTV volume limitation applicable to repurchases made in reliance upon Rule 10b-18 increases to 100% of a security's ADTV. This new exception mirrors a temporary increase in the volume limitation granted by the SEC in the immediate aftermath of the September 11, 2001 attacks.

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This memorandum is for general informational purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate developments, can be obtained from our website, www.simpsonthacher.com.