

SEC Proposes Amendments to Rule 10b-18 Safe Harbor for Issuer Repurchases

The SEC has issued for public comment proposed amendments to Rule 10b-18 under the Securities Exchange Act of 1934 that are intended to clarify and modernize the safe harbor provisions in light of market developments since the Rule's adoption in 1982.¹ Comments are due 30 days from publication in the Federal Register.

Among other things, the SEC proposes the following amendments:

- **Time condition:** The proposals would modify Rule 10b-18's timing condition to preclude Rule 10b-18 purchases as the opening purchase in the principal market for the security and in the market where the purchase is effected (in addition to the current prohibition against effecting Rule 10b-18 purchases as the opening purchase reported in the consolidated system).
- **Price condition:** The amendments would except from the Rule's price condition Rule 10b-18 purchases effected on a VWAP basis, provided that certain criteria are met.
- **"Flickering quotes":** The proposal would limit the disqualification provision of the Rule in instances where an issuer's repurchase order is entered in accordance with Rule 10b-18's four conditions but is, immediately thereafter, executed outside of 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.
- **"Merger exclusion" provision:** The proposal would modify the "merger exclusion" provision to extend the time in which the safe harbor is unavailable in connection with an acquisition by a special purpose acquisition company ("SPAC").

Amendments to the Time Condition

Under the current Rule 10b-18, to qualify for the safe harbor, an issuer's purchase may not be the opening regular way purchase reported in the consolidated system. An issuer's purchase may, however, be the opening purchase in the principal market for its security and the opening purchase in the market where the purchase is effected, provided there is already an opening purchase reported in the consolidated system that day. For example, if the principal market has a delayed opening in the issuer's stock and therefore is not the opening purchase reported in the consolidated system that day, the issuer would be able to effect a Rule 10b-18 purchase as the opening purchase in the principal market for its security that day.

The Proposing Release notes that there has been confusion in the market as to which opening transaction Rule 10b-18's opening purchase limitation applies when there is a delayed opening in the principal market for a stock. In addition, the release explains that because the principal market's official opening price has become a widely-recognized benchmark within the industry, the SEC "is concerned that this much larger official opening transaction in the principal market may be a more significant

¹ Purchases of Certain Equity Securities by the Issuer and Others, Exchange Act Release No. 34-61414 (Jan. 25, 2010) (the "Proposing Release"), available at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.

indicator of the direction of trading, the strength of demand, and the current market value of a security than the smaller regional exchange's opening purchase reported in the consolidated system that day."

To address these developments, the SEC's proposed amendments would amend the Rule to exclude from the safe harbor a purchase that is the opening purchase in either the principal market for the security or in the market where the purchase is effected (in addition to the current limits on the opening purchase in the consolidated system). The Proposing Release requests comment on whether the proposed opening purchase limitation is appropriate and whether the limitation should apply to repurchases of OTC Bulletin Board and Pink Sheet Securities.

Amendments to the Price Condition

As a condition to its safe harbor protections, Rule 10b-18 currently limits an issuer to bidding for or buying its security at a purchase price that is no higher than the highest independent bid or last independent transaction price, whichever is higher, quoted or reported in the consolidated system at the time the purchase is effected. The Proposing Release would provide an exception to the price condition for Rule 10b-18 purchases effected on a volume-weighted average price ("VWAP") basis, provided the following criteria are met:

- The purchase is for a security that 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 matched trade must be determined based on a full trading day's volume (*i.e.*, no intra-day VWAP);
- The purchase does not exceed 10% of the security's relevant average daily trading volume ("ADTV");
- 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:
 - calculating the values for every regular way trade reported in the consolidated system during the regular trading session (*i.e.*, not based only in the principal market, so no use of Bloomberg ".N" or ".Q" pages);
 - compiling an aggregate sum of all values; and
 - dividing the aggregate sum by the total number of trade reported shares for that day in the security that represent regular way trades effected in accordance with the Rule's timing and pricing conditions that are reported in the consolidated system during the primary trading session for the security;
- The VWAP assigned to the purchases must be based on trades effected in accordance with the Rule's timing and price conditions (*i.e.*, it must be "10b-18 VWAP");
- The purchase is reported using a special VWAP trade modifier (*e.g.*, a ".W") in order to indicate to the market that such purchases are unrelated to the current or closing price of the security.

The Proposing Release explains that the SEC is also considering whether to except other passive pricing mechanisms, such as the mid-point of the national best bid and offer (NBBO) or "mid-peg" orders, from Rule 10b-18's price condition. The release specifically requests comment on the prudence of expanding the proposed exception for purchases effected through these electronic trading systems.

Amendments Concerning “Flickering Quotes”

Current Rule 10b-18 provides that failure to meet any one of its manner, timing, price and volume conditions with respect to any of the issuer’s repurchases during a given day will disqualify all of the issuer’s Rule 10b-18 purchases from the safe harbor for that day. The SEC notes in the Proposing Release that “flickering quotes” have “made it increasingly difficult for an issuer to ensure that every purchase of its common stock during the day will meet the Rule’s current price condition.” Flickering quotes occur when there are rapid and reported changes in the current national best bid during the period between identification of the current national best bid and the execution or display of the Rule 10b-18 bid or purchase. As a result, in many active stocks, the price of a trading center’s best displayed quotations can change multiple times in a single second.

In order to accommodate the increasing occurrence of flickering price quotations, the Proposing Release would limit the disqualification provision in Rule 10b-18 in instances where an issuer’s repurchase order is entered in accordance with the Rule’s four conditions but fails to meet the price condition solely because of flickering quotes. In such 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.

Amendments to the “Merger Exclusion” Provision

The proposed amendments would also add a provision that extends the time in which the safe harbor is unavailable or limited in connection with a SPAC acquisition until the completion of the vote by the target and SPAC shareholders. The current Rule precludes or limits purchases effected during the period from the time of public announcement of a merger, acquisition or similar transaction involving a recapitalization, until the earlier of the completion of the transaction or the vote by the target shareholders.

The Proposing Release explains that extending the “merger exclusion” to the time of the vote by the shareholders of the SPAC (and not just the vote by the target shareholders) would “maintain reasonable limits on the Rule 10b-18 safe harbor and prevent it from being used in contexts where there is heightened incentive to engage in substantial repurchase activity solely in order to facilitate a corporate action. The benefit of a safe harbor is only appropriate during ‘normal’ market conditions.”

Other Requests for Comments

In the Proposing Release, the SEC also requests comments on a number of additional questions, including:

- Should the safe harbor’s price condition be modified to except electronic trading systems that effect issuer repurchases at the mid-point of the NBBO?
- Should the safe harbor be available during periods when an issuer’s insiders are selling shares?
- Should the safe harbor be made available to securities other than common equity, such as preferred stock, warrants, rights, convertible debt securities or other products? If so, what price, volume and time of purchase conditions should apply?
- Should the safe harbor be available for repurchases involving futures or options contracts? Should the number of shares underlying an option or security futures contract (or other derivative security) count against an issuer’s 25% daily volume limitation?
- What manipulative concerns are raised by alternative or novel methods of repurchasing securities (e.g., use of derivatives, accelerated share repurchase programs or share accumulation programs)?
- How should the safe harbor apply to repurchases outside of the United States (e.g., on foreign exchanges)?

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact

Daniel N. Budofsky	212 450 4907	daniel.budofsky@davispolk.com
James T. Rothwell	212 450 4806	james.rothwell@davispolk.com
Lanny A. Schwartz	212 450 4174	lanny.schwartz@davispolk.com
Robert L.D. Colby	202 962 7121	robert.colby@davispolk.com
Katia Brener	212 450 4465	katia.brener@davispolk.com

© 2010 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.