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SEC Amends Share Repurchase Safe Harbor and Adopts New Share Repurchase Disclosure Requirement

By Michael L. Zuppone

Introduction

On October 22, 2003, the Securities and Exchange Commission approved amendments to Rule 10b-18 under the Securities Exchange Act of 1934 (the "Exchange Act"), a safe harbor regulation under which issuers can conduct open market share repurchases without the risk of liability for unlawful manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act.¹ Given the potential for such liability, virtually all share repurchase programs are undertaken in a manner that satisfies the manner, time, price, and volume conditions of the Rule 10b-18 safe harbor. The amendments to Rule 10b-18 are intended to simplify and update the safe harbor provisions in light of developments since the adoption of the original rule. The SEC also adopted new rules requiring issuers to disclose information concerning share repurchases in their periodic reports. In summary, the SEC's rulemaking does the following:

- Modifies the existing block exception to the volume condition to include block trades in the volume limitation calculation, or alternatively, permits the purchase of one block per week;
- Eases the timing condition to allow certain issuers that meet an average daily trading volume and public float test to stay in the market longer and qualify for the safe harbor;
- Extends the safe harbor to certain after-hours repurchases;
- Amends the pricing condition to apply a uniform price limit for all issuers;
- Increases the volume limitation to 100% of average daily trading volume following a market-wide suspension;

- Clarifies the scope of safe harbor eligibility, among other things, with respect to mergers, acquisitions and similar transactions; and
- Requires periodic quarterly disclosure of all issuer repurchases (whether or not made pursuant to the safe harbor) including, among other things:
 - The total number of shares repurchased;
 - The average price paid per share; and
 - The number of shares repurchased as part of a publicly announced plan or program.

The amended and new rules will be effective on December 17, 2003, with the exception of the new disclosure requirements applicable to closed-end funds which are effective July 15, 2004.

Amendments to Rule 10b-18

Clarifications

The SEC amended Rule 10b-18 to clarify the scope and application of the safe harbor as follows:

- An issuer's repurchases must satisfy (on a daily basis) each of Rule 10b-18's four purchase conditions (manner, timing, price and volume), and failure to meet any one of the four purchase conditions on a particular trading day removes all of the issuer's repurchases from the safe harbor for that day. The Rule 10b-18 safe harbor is not available for repurchases that, although made in technical compliance with Rule 10b-18, are part of a plan or scheme to evade the federal securities laws.
- Rule 10b-18 only applies to common equity securities (*i.e.* common stock or equivalent

interest, including a unit of beneficial interest in a trust or limited partnership or a depository share).

- Repurchases effected between the time of announcement of a merger, acquisition, or similar transaction involving a recapitalization and the earlier of the completion of such transaction or the completion of the vote by 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 a merger, acquisition, or similar transaction) are excluded from Rule 10b-18's safe harbor provisions. This exclusion does not extend to:
 - transactions in which the consideration is solely cash and there is no valuation period (i.e. where the issuer has little or no incentive to manipulate the market price of its securities);
 - ordinary Rule 10b-18 purchases to be effected after the announcement of the merger or covered transaction are allowed (subject to Regulation M and any other applicable restrictions) so long as the total amount of the repurchases effected on any single day does not exceed the lesser of 25% of the security's four-week average daily trading volume or the issuer's average daily Rule 10b-18 repurchases during the three full calendar months preceding the date of the announcement of the merger or other covered transaction (in effect limiting such repurchases to actual pre-announcement repurchase volume); and
 - block purchases made within the safe harbor provided they do not exceed the average size and frequency (e.g. once a week or once a month) of block purchases made within the safe harbor during the three calendar months prior to the date of announcement.

Modification of Conditions

In addition, the SEC modified the four purchase conditions of the Rule 10b-18 safe harbor as follows:

Manner of Purchase Condition – Consistent with the rule's single broker or dealer requirement, an issuer can effect purchases directly through an electronic communication network ("ECN") or an alternative trading system ("ATS"). An issuer cannot effect purchases directly through both an ECN or other ATS and a non-ECN or other non-ATS broker-dealer on any single day. A single broker or dealer engaged by the issuer can access an ECN or other ATS to execute trades in connection with repurchase activity on behalf of the

issuer (the ECN or ATS would simply be acting as an execution venue or market center.)

Timing Condition – Issuers with more trading liquidity (i.e. an issuer with an average daily trading volume of \$1 million or more and a public float value of \$150 million or more) may bid for or purchase their common equity securities after the opening transaction up to the last ten (10) minutes before the scheduled close of the primary trading session on the principal market for such security. This represents an expanded time-frame from the last half-hour restriction that remains in effect for other eligible issuers. All other eligible issuers (i.e. issuers having an average daily trading volume of less than \$1 million or a public float value of less than \$150 million) may not bid for or purchase their common equity securities during the last 30 minutes before the scheduled close of the primary trading session on the principal market for their securities.

Price Condition – The amendment simplifies and updates Rule 10b-18 by replacing outdated definitions and price provisions. An issuer is still required to purchase its common equity 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 those securities that are not quoted or reported in the consolidated system, the issuer must look to the highest independent bid or the last independent transaction price, whichever is higher, that is displayed and disseminated on any national securities exchange or on any inter-dealer quotation system that displays at least two independent priced quotations for the securities. For all other securities, the issuer must look to the highest independent bid obtained from three independent dealers.

Volume Condition – To qualify for the safe harbor, an issuer's total volume of 10b-18 purchases effected on any single day must not exceed 25% of the security's preceding four week average daily trading volume, which includes any block-size purchases by or on behalf of the issuer for that day. This represents a change from the prior rule which excluded block purchases from daily volume limitation. Issuers, however, can include their block-size purchases when calculating the four-week average daily trading volume. Alternatively, issuer's can effect block purchases once per week, provided that the issuer does not make any other Rule 10b-18 purchases on that day. A block purchase made under this alternative must be excluded from the calculation of the security's four-week average daily trading volume. During the trading session immediately following a market-wide trading suspension, the volume limitation is increased to 100% of a security's four week average daily trading volume and the timing condition does not apply, permitting purchases until the close of trading.

Riskless Principal Transactions

Rule 10b-18 now explicitly applies to riskless principal transactions, that is, transactions where a broker or dealer, after having received an order from an issuer, buys the issuer's security as principal and then sells the security to the issuer to satisfy the issuer's buy order. The issuer's second leg purchase must be effected at the same price per-share paid by the broker or dealer in the first leg open market purchase, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee. Only the broker's or dealer's first leg open market purchase must be disclosed under the new disclosure rules (discussed below). The broker or 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 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.

After-Hours Trading

The Rule 10b-18 safe harbor has been extended to repurchases effected during after-hours trading. After-hours repurchases must be effected at prices that do not exceed the lower of the closing price of the primary trading session in the principal market for the common equity security and any lower bids or sales prices subsequently reported in the consolidated system by other markets. These purchases would have to comply with the other three safe-harbor conditions with slight modifications:

- Manner – The issuer may use a different broker or dealer for after-hours trading than was used during normal market hours.
- Timing – The trade cannot be the first after-hours trade in the security, however, trading can continue until the end of the after-hours trading session.
- Volume – The volume calculation would carry over from the regular trading session.

New Disclosure Requirement

As noted above, the new disclosure requirements will require periodic quarterly disclosure of issuer repurchase activity. The SEC's aim with the new disclosure requirements is to enhance transparency of issuer repurchases. The SEC adopted amendments to Forms 10-Q and 10-QSB and Forms 10-K and 10-KSB and Regulations S-K and

S-B (adding new Item 703) which require issuers to disclose in a prescribed tabular format information concerning repurchases of any class of equity securities registered under Section 12 of the Exchange Act made by the issuer or any "affiliated purchaser."² The new table requires disclosure of all issuer repurchases effected in both open market and private transactions during the last fiscal quarter. The issuer must disclose:

- the total number of shares purchased each month during the period covered by the table;
- the average price paid per share;
- the total number of shares purchased as part of a publicly announced repurchase plan or program; and
- the maximum number, or approximate dollar value, of shares that may yet be purchased under the repurchase plans or programs.

Any issuer with a publicly announced repurchase plan or program is required to disclose, in a footnote to the table, the principal terms of such plan or program, including:

- the date of announcement of such plan or program;
- the share or dollar amount approved;
- the expiration date of such plan or program, if any;
- 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.

The table also must include footnotes that briefly disclose the nature of the transaction for any purchase made other than pursuant to a publicly announced repurchase plan or program. These include, by way of example, open market and privately negotiated purchases, issuer tender offers and purchases made by the issuer upon another person's exercise of outstanding put rights.

Foreign Private Issuers

The Rule 10b-18 safe harbor applies only to issuer repurchases in the United States. The SEC decided not amend the safe harbor to extend eligibility to purchases made in non-U.S. markets.

Foreign private issuers must comply with the new disclosure requirement which is contained in Item 16(e) of Form 20-F. Form 20-F requires the same tabular presentation (including the footnoted information concerning publicly announced plans or programs) as required by U.S. domestic companies, except that the disclosure is required to be made on a yearly basis. Foreign private issuers must disclose repurchases of ordinary shares themselves or depositary receipts that represent ordinary shares. The price and other data must be stated in the same currency used in the issuer's primary financial statements.

Closed End Funds

The Rule 10b-18 safe harbor is available for closed-end funds. Closed-end funds are required to provide the required disclosure regarding their repurchases semi-annually on Form N-CSR. The SEC eliminated the current requirement for closed-end funds to disclose information regarding privately negotiated repurchases on Form N-23C-1. The SEC also made conforming technical

amendments to Rule 23c-1 under the Investment Company of 1940 and Form N-CSR to require a closed-end fund to file as an exhibit a copy of any written solicitation to purchase securities under Rule 23c-1 sent or given by or on behalf of the fund to 10 or more persons.

Notes

1) See SEC Release Nos. 33-8335; 34-48766; IC-26252 (November 10, 2003).

2) An affiliated purchaser is (i) a person acting, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities or (ii) an affiliate who, directly or indirectly, controls the issuer's purchases of such securities, whose purchases are controlled by the issuer, or whose purchases are under common control with those of the issuer; provided, however, that "affiliated purchaser" shall not include a broker, dealer, or other person solely by reason of such broker, dealer, or other person effecting Rule 10b-18 purchases on behalf of the issuer or for its account, and shall not include an officer or director of the issuer solely by reason of that officer or director's participation in the decision to authorize Rule 10b-18 purchases by or on behalf of the issuer.

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