SEC Proposes Amendments to the Stock Repurchase Safe Harbor and Requests Comments

02.25.2010 | UPDATES

The Securities and Exchange Commission has proposed amendments to clarify and modernize Rule 10b-18 of the Securities Exchange Act of 1934 that governs public companies' repurchases of their common stock. The SEC is accepting comments to these proposed amendments through March 1, 2010. This Update summarizes the key issues in the proposed amendments and alerts you to the opportunity to make comments on the proposal.

Background on Rule 10b-18

Rule 10b-18 provides an issuer with a "safe harbor" from liability for manipulation of its stock price (under Section 9(a)(2), Section 10(b) and Rule 10b-5 of the Exchange Act) when repurchasing its shares in the open market. To qualify for the safe harbor for any given day, the issuer must satisfy each of the manner, timing, price and volume conditions of the rule. If the issuer fails to meet any one of the rule's conditions, the repurchases are disqualified from the safe harbor for that day.

Proposed Amendments to Rule 10b-18's Safe Harbor

If adopted, the proposed amendments would generally modernize Rule 10b-18's safe harbor to take into account market developments since the adoption of the rule in 1982 in a manner that will be welcome to issuers. For example, the SEC proposes to amend the safe harbor price condition to allow issuers to repurchase their shares on a volume-weighted average price, or VWAP, basis and to provide that a trade that violates the rule's price condition solely as a result of "flickering" quotes will not disqualify all safe harbor trades made that day. However, issuers may want to provide input on the specifics of the proposed changes, such as potentially requiring detailed recordkeeping or the maintenance of written policies and procedures as a condition for utilizing the VWAP exception.

Price Condition: VWAP Pricing Permitted.

Currently, the price condition of Rule 10b-18 provides that issuers may repurchase their securities at a purchase price that does not exceed the highest independent bid or the last independent transaction price, whichever is higher, reported in the consolidated system. The SEC's proposed amendment would except from the price condition purchases made on a VWAP basis in certain circumstances. VWAP prices are generally calculated by adding up the dollar amounts traded for each transaction in the security and then dividing by the total number of shares traded for the day. Because VWAP transactions may be priced without reference to the quoted price of the stock at the time of execution, many issuers that repurchase their shares using these trading strategies must currently forego the protections of the safe harbor.

Requirements of the Proposed VWAP Exception. To qualify for the proposed VWAP exception, the VWAP purchase must meet the following standards:

- The purchased security must qualify as an actively-traded security under Rule 101(c)(1) of Regulation M (meaning it has an average daily trading volume value of $1 million or more and a public float of $150 million or more).
- The purchase must be entered into or matched before the regular trading session opens, and the execution price of the matched trade must be determined based on a full trading day's volume.
- It must not exceed 10% of the average daily trading volume in the security and must not be made for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.
- The purchase must be reported using a special VWAP trade modifier in order to indicate to the market that the purchase is unrelated to the current or closing price of the security.
- Other technical guidelines about how to calculate the VWAP price must be observed.

The SEC is considering whether to except other passive pricing mechanisms as well, such as electronic trading systems that use passive or independently derived pricing mechanisms.

Specific Comments Sought. The SEC is seeking specific comments on a number of aspects relating to the proposed price condition amendments, including whether a standard other than the actively-traded standard should be used, or whether issuers must have certain written policies and procedures as well as supervising systems in place to allow reconstruction of all VWAP orders before relying on the proposed VWAP exception.
Timing Condition: Issuer Purchases May Not Be the Opening Purchase. Currently, under the timing condition of Rule 10b-18, the safe harbor does not apply to purchases made during the last half-hour (or during the last ten minutes for actively-traded securities) before the scheduled close of both the principal market for the security and the market where the purchase is effected. Additionally, Rule 10b-18 requires that an issuer's stock purchase may not be the opening purchase reported in the consolidated system. However, if there is already an opening purchase reported in the consolidated system that day, this condition allows an issuer's stock purchase to be the opening purchase in the principal market for its security and the opening purchase in the market where the purchase is made.

The SEC's proposed modification to the timing condition would preclude, without exception, issuer purchases as the opening purchase in the principal market for the security and in the market where the purchase is made, in addition to the current prohibition on issuers opening purchases in the consolidated system.

Volume Condition: Minor Conforming Change Proposed. The volume condition of Rule 10b-18 restricts an issuer to daily purchases in an amount up to 25% of the average daily trading volume in its shares, or alternatively, a once-a-week purchase of a "block" of its common stock in lieu of purchasing under the 25% volume limitation for that day. The SEC has proposed a "non-substantive conforming change" to Rule 10b-18 that would replace "trading volume" with "average daily trading volume" in the definition of "block."

Manner Condition: No Changes Proposed. The SEC has not proposed changes to the "manner" condition. Issuers would still be required to use a single broker or dealer on a given day to bid for or purchase their common stock.

"Flickering Quotes" Would Not Disqualify Purchases. Generally, if an issuer fails to meet any one of the rule's conditions, all of the issuer's purchases are disqualified from the safe harbor for that day. The SEC is proposing to limit this general disqualification provision of Rule 10b-18 in instances where an issuer's repurchase order is entered in accordance with the four conditions of Rule 10b-18 but is, immediately thereafter, executed outside the price condition solely due to flickering quotes. "Flickering quotes" occur when there are rapid and repeated changes in the current best bid during the period between identification of the best bid and the execution of the bid. In these instances, only the noncompliant purchase, rather than all the issuer's Rule 10b-18 purchases for that day, would be disqualified from the safe harbor.

Merger Exclusion: More Stringent Exclusion Period for SPACs. The definition of a "Rule 10b-18 purchase" includes an exclusion from the availability of the safe harbor during certain corporate events, including when an issuer is under pressure to complete a merger or similar corporate action. Currently, the target shareholder vote determines the completion of the merger exclusion period. The SEC's proposal describes the increased use of special purpose acquisition companies, or SPACs, in capital raising and the unique pressures on SPACs to identify, target and obtain approval of a transaction by both the SPAC shareholders and the target shareholders within an 18 to 24 month period. Accordingly, the proposed amendment would extend the time during which the safe harbor is unavailable in connection with an acquisition until the completion of the vote by the target shareholders and by the SPAC shareholders.

SEC Requests Comments

The SEC is also soliciting comments on other aspects of Rule 10b-18 that do not relate to the proposals discussed above, which may ultimately lead to an overhaul of the rule. For example, the SEC is seeking comments on whether the Rule 10b-18 safe harbor should, among other things, be made available for issuer repurchases of securities other than common equity (e.g., preferred stock, warrants or convertible debt) or involving security futures or option contracts, or require specific disclosure by issuers relying on the safe harbor.

Perkins Coie will be assisting the Committee on Federal Regulation of Securities, Section of Business Law of the American Bar Association in the preparation of a comment letter on the proposed amendments to Rule 10b-18. You should feel free to contact us if you have any comments on the proposed amendments that you would like to be considered as part of that process.

Additional Information

This Update is intended to be only a summary of the SEC's proposed amendments. View full text of the proposed amendments. You can find discussions of other recent cases, laws, regulations and rule proposals of interest to public companies on our Web site.

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