

SEC Proposes Amendments to Issuer Repurchase Rule (Rule 10b-18)

January 27, 2010

On January 25, the Securities and Exchange Commission (SEC) proposed changes to Rule 10b-18—the issuer repurchase rule under the Securities Exchange Act of 1934 (Exchange Act). Rule 10b-18 provides a safe harbor for open-market common stock purchases by the issuer and by affiliated purchasers, such as directors and executive officers. Under this nonexclusive safe harbor, issuers (and their affiliated purchasers) will not be deemed to have violated the Exchange Act anti-manipulation rules if they comply with the following provisions of the Rule regarding the method, timing, price and amount of their common stock purchases:

1. **One Broker or Dealer on a Single Day** - All bids for, or purchases of, an issuer's common stock must be made through only one broker or dealer on a single day. This broker or dealer, who will be soliciting bids for and purchases of the common stock for the issuer (and for any affiliated purchasers who may be in the market on a given day) could be a different broker or dealer each day. The rule is intended to prohibit a purchaser from having numerous brokers or dealers entering bids for or making purchases of the common stock at the same time.

With respect to after-hours trading (from the close of the primary trading session until the termination of the period in which last sale prices are reported in the consolidated system), Rule 10b-18 permits an issuer to use one additional broker-dealer for after-hours trading, in recognition of the fact that it may not be possible to use the same broker for after-hours trading as the issuer used during normal trading hours.

2. **Timing** - Rule 10b-18 prohibits an issuer from effecting the opening purchase reported on the consolidated system. Rule 10b-18 generally prohibits an issuer from effecting purchases during the last 30 minutes of trading. However, because transactions by issuers of highly liquid securities are less likely to influence market prices and volume, the rule shortens the end-of-trading-day limitation for such issuers from 30 minutes to 10 minutes. The issuers that are subject to the shortened restriction are those with an "ADTV" (defined below) of \$1 million or more and a public float value (the aggregate market value of voting and nonvoting common equity held by nonaffiliates) of \$150 million or more. The last-10-minutes or last-30-minutes restriction applies to the scheduled close of trading on the primary trading session both in the principal market for the security and in the market where the purchase is made.

"ADTV" is the average daily trading volume reported for the security during the four calendar weeks preceding the week in which the Rule 10b-18 purchase is to be effected.

The rule addresses timing limitations in connection with after-hours trading. Subject to the one-broker limitation discussed above and the price limitation discussed below, an issuer may repurchase its securities following the close of the primary trading session until the termination of the period in which last sale prices are reported in the consolidated system. However, the Rule 10b-18 purchases may not be the opening transaction of the session following the close of the primary trading session.

3. **Price** - Bids and purchases may not be at a purchase price that is higher than the greater of (a) the highest independent bid or (b) the last independent transaction price at the time the Rule 10b-18

purchase is effected. The purchase price excludes any commission paid to a broker acting as agent, or any commission equivalent, mark-up, or differential paid to a dealer.

4. **Volume** - The total volume of Rule 10b-18 purchases effected by or for the issuer and any affiliated purchasers on any single day must not exceed 25% of the ADTV (as defined above) for that security. However, once each week, in lieu of purchasing pursuant to the 25% of ADTV limit for that day, the issuer or an affiliated purchaser of the issuer may effect one "Block" purchase if (a) no other Rule 10b-18 purchases are effected that day, and (b) the Block purchase is not included when calculating a security's four week ADTV under this section.

A "Block" purchase means the purchase of a quantity of common stock that meets one of the following criteria:

- i. It has a purchase price of \$200,000 or more
- ii. It totals at least 5,000 shares and has a purchase price of at least \$50,000
- iii. It comprises at least 20 round lots and totals 150% or more of the trading volume for that stock

A Block purchase excludes (a) amounts accumulated by a broker or dealer for sale to the issuer or affiliated purchaser and (b) amounts sold short, if the issuer or affiliated purchaser knows or has reason to know of such accumulation or short sale. A Block purchase is not exempt from any conditions of Rule 10b-18 other than the volume limitations.

Proposed Changes

The SEC has proposed several changes to the purchase conditions under Rule 10b-18. These include the following:

- Modification of the 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. This limitation would be in addition to the current prohibition against effecting Rule 10b-18 purchases as the opening purchase transaction as reported in the consolidated system.
- Relaxation of the price condition for certain Volume Weighted Average Price (VWAP) transactions. Currently, because VWAP transactions are priced on the basis of individual trades that are executed and reported throughout the trading day, there may be instances where the execution price of an issuer's VWAP purchase effected at the end of the trading day (after the security's VWAP has been calculated and assigned to the transaction) exceeds the highest independent bid price quoted or reported in the consolidated system for that security and therefore, will be outside the safe harbor's current price condition. To provide issuers with additional flexibility to conduct repurchase programs using VWAP, the SEC is proposing a new VWAP exception to the pricing condition.

To qualify for the new VWAP exception, certain conditions must be satisfied. First, the VWAP purchase must involve a security that qualifies as an "actively traded security" (as defined in Rule 101(c)(1) of Regulation M under the Exchange Act). The VWAP purchase must be entered into or matched before the regular market opens and the execution price of the VWAP-matched trade must be based on a full trading day's volume. The issuer's VWAP purchases must not exceed 10% of the ADTV in the security and must not be effected for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security. The VWAP must be calculated in accordance with a prescribed methodology, and the VWAP assigned to the issuer repurchase must be based on transactions that comply with Rule 10b-18's timing and price conditions. Finally, the VWAP trade must be reported to the consolidated system with the appropriate VWAP trade modifier.

In addition to the proposed new VWAP exception, the SEC indicated that it is considering other changes to the Rule 10b-18 price condition. In particular, the SEC indicated that it was considering expanding the proposed exception to include issuer transactions effected through electronic trading systems that match and execute trades at independently derived prices, such as orders effected at the mid-point of the national best bid or offer (Mid-Peg Orders).

In addition, the SEC indicated that is considering whether to except from Rule 10b-18's price condition purchases that are effected in an electronic trading system that matches buying and selling interest at various times throughout the day if, for example, each of the following conditions are present:

- i. Matches occur at an externally derived price within the existing market and above the current national best bid
 - ii. Sellers and purchasers are not assured of receiving a matching order
 - iii. Sellers and purchasers do not know when a match will occur
 - iv. Persons relying on the exception are not represented in the primary market offer or otherwise influence the primary market bid or offer at the time of the transaction
 - v. Transactions in the electronic trading system are not made for the purpose of creating actual, or apparent, active trading in, or depressing or otherwise manipulating the price of, any security
 - vi. The covered security qualifies as an "actively traded security" and
 - vii. During the period of time in which the electronic trading system may match buying and selling interest, there is no solicitation of customer orders, or any communication with customers that the match has not yet occurred
- Limitation of the disqualification provision of Rule 10b-18 in fast-moving markets. Currently, Rule 10b-18 provides that the failure to meet any one of its four conditions with respect to any of the issuer's repurchases during the day will disqualify all of the issuer's Rule 10b-18 purchases from the safe harbor for that day. To deal with the phenomenon of "flickering quotes," the SEC is proposing to limit this disqualification in instances where an issuer's repurchase order is entered in accordance with Rule 10b-18's conditions but is executed outside of the price condition due to "flickering quotes." In these instances, only the noncompliant purchase would be disqualified from the safe harbor.
 - Change to the "merger exclusion" provision. The proposed amendments would also add a provision that extends the time in which the safe harbor is unavailable in connection with a SPAC acquisition until the completion of the vote by the SPAC shareholders (in addition to a vote of the target shareholders). This change is intended to prevent the safe harbor from being used in situations where there is a heightened incentive for the issuer to engage in substantial repurchase activity solely to facilitate a corporate action (for example, a favorable vote on a SPAC acquisition).

The SEC's proposing release is available at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.

If you have any questions or would like more information regarding any of the proposed changes discussed in this Investment Management FYI, please contact any of the following Morgan Lewis attorneys:

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