

Client Alert

A report
for clients
and friends
of the firm November 2003

SEC's Rule 10b-18; New Disclosure Requirements

On October 22, 2003, the Securities and Exchange Commission adopted amendments to Rule 10b-18, its "safe harbor" rule for company repurchases of their equity securities on any given day. These amendments and new related disclosure requirements will significantly impact repurchasing companies, particularly companies whose common stock is not listed on a stock exchange or quoted on NASDAQ.

In Securities Act of 1933 Rel. No. 8335 (November 10, 2003) (the "Adopting Release"),¹ the SEC adopted the previously approved amendments to Rule 10b-18, which provides a "safe harbor" from certain anti-manipulative provisions of the Securities Exchange Act of 1934 (the "Exchange Act") and the SEC's rules² for companies repurchasing their own equity securities. In addition to the provisions of the Rule itself, the Adopting Release includes footnotes and text, which are not codified in the Rule or published in the Code of Federal Regulations, which contain a number of interpretations and explanations of the Rule that companies, their legal advisers and market profes-

sionals should be aware of, due to the highly complex and technical nature of the provisions of the Rule.

The amendments to Rule 10b-18 become effective on or about December 17, 2003.

The new disclosure requirements are effective as follows.

- Items 703 of Regulations S-B and S-K, Forms 10-Q, 10-QSB, 10-K and 10-KSB — periods ending on or after March 15, 2004; and
- Item 16E of Form 20-F — reports on Form 20-F for fiscal years ending on or after December 15, 2004.³

Summary of the Provisions of Rule 10b-18

Rule 10b-18 provides a "safe harbor" from the anti-manipulative provisions of Sections 9(a)(2) and 10(b) of the Exchange Act and SEC Rule 10b-5⁴ for companies and their "affiliated purchasers"⁵ bidding for or purchasing the companies' equity securities which comply with the timing of purchases, volume of purchases and price of purchases provisions of the Rule and use only one securities broker in any one day to make the purchases.⁶ While use of the Rule is voluntary and it is not the exclusive means for companies making non-manipulative purchases of their

¹ These amendments were proposed in Rel. 33-8160 (the "Proposing Release"). This client alert does not address the applicability of these amendments or the new disclosure rules on registered investment companies. The Rule is not intended to define appropriate limits for persons not covered by the Rule or for purchases of securities other than common equity interests. See Adopting Release, footnote 6. The rule is not available for repurchases using forward contracts, accelerated share repurchase programs, put writing, call purchasing or purchases of stock upon exercise of options.

² Sections 9(a)(2) and 10(b) of the Exchange Act and Rule 10b-5.

³ Canadian issuers filing on Form 40-F are not subject to these disclosure requirements.

⁴ The rule does not provide a safe harbor from the insider trading provisions of Rule 10b-5 or from liability for materially misleading statements or omissions subject to that rule. See Adopting Release, footnote 5 (insider trading); cf. Adopting Release, footnote 110 (an issuer which announces a repurchase program, but has no intention of making any purchases may violate the antifraud and anti-manipulative provisions of the Exchange Act). Nor does Rule 10b-18 provide a safe harbor for a company with a manipulative purpose for purchasing its equity securities. (Rule 10b-18 provides that an issuer will not violate the anti-manipulative provisions of the Exchange Act "solely" by reason of purchases that comply with the Rule.) See Preliminary Note 1; Adopting Release footnotes 19, 24 and 38 and accompanying text (The Rule does not protect purchases that are part of a plan or scheme to evade the federal securities laws).

⁵ The term "affiliated purchaser" is one of the more difficult terms of Rule 10b-18 to understand due to the apparent distinctions between that term and the term "affiliate" (a "controlling" or "controlled" person). An "affiliated purchaser" is a person acting, directly or indirectly, "in concert" with the issuer for purposes of acquiring its securities, and any "affiliate" of the issuer that controls its purchases or whose purchases are controlled by the issuer or are under common control with the issuer's purchases. Persons "acting in concert" with the issuer include persons acting with the issuer, even if they do not purchase securities for the issuer's account. See Adopting Release, footnote 45. The term does not include a broker-dealer effecting purchases for the issuer or officers or directors solely by reason of their participating in the decision to authorize the issuer's purchases.

⁶ The single broker may be an electronic communications network ("ECN") or other alternative trading system ("ATS"). See Adopting Release III.B.1. Also, a single broker for the company may effect covered purchases through one or more ECNs or ATSS.

securities,⁷ the SEC has provided little guidance as to what other means a company could use to avoid these anti-manipulative provisions⁸ and it has observed that it understands that companies generally are reluctant to make repurchases without the certainty of the safe harbor.⁹

The Rule specifically does not provide a safe harbor for purchases during the following corporate events, which are deemed not to involve “Rule 10b-18 purchases” (“covered purchases”):

- With the exceptions listed below, mergers, acquisitions or similar transactions involving a recapitalization from the time they are “publicly announced”¹⁰ until the earlier of the completion of the transaction or the vote by the shareholders of the target company, except with respect to:
 - transactions where the consideration is solely cash and there is no valuation period; or
 - transactions that are not otherwise restricted or prohibited where the total volume of covered purchases does not exceed the lesser of 25% of the security’s four-week average daily trading volume (“ADTV”) or the average daily covered purchases during the three full calendar months preceding the date of the public announcement. (“Covered block purchases” that do not exceed the average size of the company’s covered block purchases during the three full calendar months preceding the date of the public announcement also are permissible.)¹¹
- certain tender offers;¹² and
- distributions by the issuer during a “restricted period” under Regulation M.¹³

Moreover, as discussed above, the safe harbor does not protect the purchaser from the liability provisions of the federal

securities laws for “purchases that are part of a plan or scheme to evade” those laws.

Changes from Existing Rule

*Securities covered.*¹⁴ The safe harbor covers bids for, and purchases of,¹⁵ the following (“covered securities” or “equity securities”):

- Common stock; and
- All other “common equity” securities (an interest equivalent to common stock, including a unit of beneficial interest in a trust, a limited partnership interest or a depository share, for example).

Convertible securities, preferred stock, warrants, options or other rights or security futures products that are physically settled are not covered securities.

Timing of purchases. Under the previous timing conditions, purchases in any market at the opening of trading and during the last half hour of trading were not covered purchases. Purchases at the opening still are not covered purchases. Thus, if there is no independent opening transaction on a given day, the company cannot rely on the Rule on that day.

The new rules modify the requirement for a company with a security with an ADTV of \$1 million or more and a “public float” of \$150 million or more to be out of the market before it closes.¹⁶ Those companies now may repurchase their securities or have bids entered on their behalf until 10 minutes before the scheduled close of any of the following:

- The “primary (regular) trading session” in the “principal market” for the security;¹⁷
- The primary (regular) trading session of the market in which the purchase is made; or
- Until the termination of the period during which last sale prices are reported in the “consolidated system.”¹⁸

⁷ See Rule 10b-18(d). Failure to comply with the Rule is not an independent violation of law.

⁸ In Adopting Release, the SEC states that: “[g]iven the widely varying characteristics in the market for the stock of different issuers, it is possible for issuer repurchases to be made outside of the safe harbor conditions and not be manipulative.”

⁹ See Adopting Release, Introduction and footnote 39.

¹⁰ The term “publicly announced” is defined by reference to Rule 165(f) under the Securities Act. Such a public announcement is no longer considered a “solicitation” for purposes of Rule 10b-18. See Adopting Releases, footnotes 13 and 27.

¹¹ See Rule 10b-18(a)(13)(iv).

¹² See Rule 10b-18(a)(13)(vi) and (vii). In addition, transactions pursuant to Rule 13e-1 (issuer purchases during a third-party tender offer) are not covered purchases.

¹³ See Rule 10b-18(a)(13)(i); Regulation M, Rule 100(b). In addition, transactions in fractional share interests and transactions effected for an issuer plan by an “agent independent of the issuer,” as those terms are defined in Rule 100 of Regulation M, are not covered purchases.

¹⁴ Rule 10b-18 also covers repurchases by certain registered investment companies. That coverage is not addressed in this client alert.

¹⁵ The safe harbor also applies to “limit orders” that would effect a covered purchase.

¹⁶ “ADTV” and “public float” are defined below in this client alert.

¹⁷ The “principal market” for a security is the securities market with the largest reported trading volume for the covered security during the full six calendar months preceding the week in which the covered purchase is made.

¹⁸ Under Rule 10b-18(a)(5), the term “consolidated system” means “a consolidated transaction (or quotation) reporting system that collects and publicly disseminates on a current and continuous basis transaction (or quotation) information in equity securities pursuant to an effective transaction reporting plan (as defined in 17 CFR 240.11Aa3-1), the rules of a national securities exchange, or the rules of a national securities association (i.e., NASD).”

“After-hours” trading. “After hours” trading takes place after a securities market’s regular trading sessions. Rule 10b-18 now permits purchases during limited off-hours trading (“OHT”) sessions¹⁹ while the consolidated system is still open at a price not higher than the primary market’s closing price and any subsequent price reported in the consolidated system, up until the termination of reporting of the last sale prices in the consolidated system. The company may use a different broker during these OHT sessions.

Volume of purchases – treatment of block purchases. Under the previous volume condition, a company could purchase up to 25% of the ADTV in its shares. However, “block purchases”²⁰ were not counted as Rule 10b-18 purchases and were excluded from volume calculations.

Under the new Rule, block purchases are included as Rule 10b-18 purchases for purposes of the volume calculations, but are also counted in calculating ADTV.

In addition, the new Rule would permit a company once a week to purchase a block as an alternative to the 25% volume limitation on the day that the block is purchased. However, this block cannot be included in the company’s ADTV. This should assist companies with limited trading volume.

Price of purchases. The previous price conditions varied depending upon the market for the security and the medium on which transactions in the security were traded. The amended price condition applies a uniform price provision — the price, exclusive of commissions and dealer mark-ups, may be no higher than the “highest independent bid”²¹ or the “last independent transaction price,”²² whichever is higher, quoted or reported in the “consolidated system.”

For securities that are not quoted or reported in the consolidated system, the covered purchases must be effected at a price that does not exceed the highest independent bid or the last independent transaction price, whichever is higher, displayed and disseminated on any national securities exchange or on any “interdealer quotation system” (as defined in SEC Rule 15c2-11²³) that displays at least two independent priced quotations for the security.

For all other securities, the purchases must be effected at a price no higher than the highest independent bid obtained from three dealers.²⁴

Purchases in times of market stress. The SEC amended Rule 10b-18 to permit a company to make covered purchases of up to 100% of the ADTV for the covered security if the purchases in excess of 25% of that ADTV take place after the reopening of trading following a market wide trading suspension imposed by an SRO or declared by the SEC, or an SRO “circuit breaker” is tripped, and up until closing and at the opening of the next day’s trading.

Disclosure requirements. The SEC has adopted requirements for disclosure about all repurchases by companies of their “equity securities.” The definition of the term “equity security” for these disclosure purposes is broader than the term used for purposes of Rule 10b-18. These disclosure requirements are not part of Rule 10b-18, and compliance with these disclosure requirements is not a condition to the availability of the safe harbor provided by that Rule.

The previous version of Rule 10b-18 did not include a disclosure requirement, although from time to time, one had been proposed by the SEC²⁵ and there were issues as to whether some disclosure about repurchase plans was required under the general anti-fraud provisions of SEC Rule 10b-5. In any event, most companies made some public disclosure about their repurchase plans and were required to provide some disclosure in the GAAP footnotes to their financial statements, their MD&As or other SEC disclosure requirements or their statements of changes in stockholders’ equity under GAAP. NYSE listing rules, for example, also require some periodic notice to the SRO of repurchases of shares by their listed companies. The new disclosure requirements are discussed separately below. These periodic disclosure requirements do not resolve the issues as to the advisability, timing and content of public announcements about company repurchase programs.²⁶

Some Significant Definitions and Interpretations

The SEC has included a number of interpretations and explanations of the provisions of Rule 10b-18 in the Adopting

¹⁹ For example, the NYSE’s Crossing Session I.

²⁰ The term “block,” under Rule 10b-18, means a quantity of stock with a purchase price of \$200,000 or more or at least 5,000 shares of stock with a purchase price of \$50,000 or more. The stock exchanges and NASDAQ have different definitions of blocks. A block does not include any amount a dealer, acting as principal, the company, or an affiliated purchaser, knows or has reason to know, the dealer accumulated for sale to the company or an affiliated purchaser or any short sale by the dealer to the company, or an affiliated purchaser, if the company, or an affiliated purchaser knows or has reason to know that the sale was a short sale.

²¹ As defined below in this client alert.

²² As defined below in this client alert.

²³ Rule 15c2-11 defines the term “interdealer quotation system” as: “any system of general circulation to brokers or dealers, which regularly disseminates quotations of identified brokers or dealers.”

²⁴ For example, OTC Bulletin Board and Pink Sheet securities. These securities are not subject to timing restrictions under Rule 10b-18. See Adopting Release, footnote 15.

²⁵ See Proposing Release, footnote 2.

²⁶ The content of these public announcements is subject to the antifraud provisions of Rule 10b-5.

Release, which are not included in the Rule itself. Some of the more important of these are discussed below, to the extent not discussed elsewhere in this client alert.

Interpretations

ADTV. “ADTV” means the average daily trading volume reported for the covered security during the four calendar weeks preceding the week in which the covered purchase is made. According to the SEC, it may be calculated using any reasonable and verifiable method.²⁷

Manner of Purchase. The SEC has not changed the manner of purchase condition of Rule 10b-18, which requires that all purchases in a single day must be made through a single broker or dealer. However, the SEC has stated that the single broker condition only applies to purchases “solicited” by or on behalf of a company. Although the term “solicited” is not defined for these purposes, the SEC stated, that it would not consider a company’s announcement of a repurchase program, by itself, as a solicitation by or on behalf of the company for purposes of Rule 10b-18.²⁸

Moreover, according to the SEC, the company may use a different broker during an OHT.

In addition, the SEC has stated that the company’s broker is free to make “appropriate and customary arrangements” with other broker-dealers, including stock exchange specialists and “two dollar brokers” on a stock exchange floor, to execute the company’s repurchase orders.²⁹

Definitions of Certain Technical Terms

“Rule 10b-18 purchase.” The SEC has amended the definition of “Rule 10b-18 purchase” to incorporate the definition of “Rule 10b-18 bid” and to make it clear that the term includes limit orders. A purchase of a security by an “independent agent” (as defined in Rule 100 of SEC Regulation M) pursuant to an issuer employee “plan” (as defined in Rule 100 of Regulation M) is not a purchase by an issuer or an affiliated purchaser for purposes of Rule 10b-18.

“Public float.” “Public float value” is defined by reference to Rule 100 of SEC Regulation M. It is determined in the manner set forth on the front page of Form 10-K, even if the issuer is not subject to Form 10-K filing requirements.

“Highest independent bid.” Rule 10b-18(a)(6) defines the term highest independent bid to mean “the highest published bid for a “regular way” trade (other than a bid by or for the

issuer or any affiliated purchaser of the issuer) at the time the Rule 10b-8 purchase is “effected.”

“Last independent transaction price.” Under Rule 10b-18(a)(7), the term “last independent transaction price” means “the price at which the last regular way trade (other than a trade by or for the issuer or any affiliated purchaser of the issuer) was reported [by the relevant system] at the time the Rule 10b-18 purchase is effected.”

Other

Riskless Principal Transactions. A “riskless principal” transaction is a “two legged” transaction where the dealer has a seller for the shares before it purchases the shares as principal and contemporaneously resells the shares to the issuer. Under Rule 10b-18, the first leg of the transaction, the dealer’s purchase, must comply with the Rule. In addition:

- There can be only a single self-regulatory organization reported “print” of the transaction, *i.e.*, the dealer’s purchase;
- The dealer’s price to the issuer must be the price at which the dealer purchased the shares, exclusive of markup, commissions or other fees;
- The dealer must have written procedures to assure, at a minimum, that the dealer received the company’s order before the offsetting transaction;
- The offsetting transaction must be allocated to a riskless principal account or the company’s account within 60 seconds of execution; and
- The dealer must have supervisory systems to produce records that enable the dealer to accurately and readily reconstruct, in a time-sequenced manner, all riskless principal orders.

New Disclosure Requirements

The new disclosure requirements are in addition to existing requirements for disclosure in the statement of changes in stockholders’ equity, the footnotes to the financial statements in accordance with GAAP and, where required, in the MD&A or under the general anti-fraud rules. (As discussed above in this client alert, Rule 10b-18 does not provide a safe harbor from the general anti-fraud rules under Rule 10b-5.)

These disclosure requirements, which would apply to Forms 10-Q, 10-QSB, 10-K, 10-KSB and 20-F (but not Form 40-F for certain Canadian companies),³⁰ require tabular disclosure, on a monthly basis, of all issuer and affiliated purchaser repur-

²⁷ See Adopting Release, footnote 53. However, Rule 10b-18 provides that only U.S. market trading volume data may be used in calculating ADTV.

²⁸ See footnote 13 to the Adopting Release

²⁹ See Proposing Release, footnote 14 and accompanying text.

³⁰ These disclosure requirements also would apply to certain registered investment companies. These requirements are not addressed in this client alert.

chases of the issuer's equity securities³¹ registered under Section 12 of the Exchange Act (both open market and private transactions and regardless of whether they were Rule 10b-18 purchases) in the previous quarter pursuant to Item 703 of Regulations S-K and S-B and new Item 16E of Form 20-F. Foreign companies filing annual reports on Form 20-F will only report this information on an annual basis.

The following would be required to be disclosed in a table:

- total number of shares or units purchased on a monthly basis;
- the average price paid per share;
- the number of shares or units purchased as part of a publicly announced plan or program; and
- the maximum number of shares or units or approximate dollar value that may yet be purchased under the plan or program.

The following are required to be disclosed in footnotes to the table:

- the date of any announcement of a repurchase plan or program;
- the share or dollar amount approved;
- the expiration date, if any, of the plan or program;
- plans or programs that have expired during the period covered by the report; and
- plans or programs under which the company has determined not to make any more purchases or has determined to terminate before expiration.

In addition, additional footnotes must briefly disclose the nature of purchases that were not made pursuant to a publicly announced plan or program, for example:

- open market purchases;
- privately negotiated purchases;
- purchases pursuant to a tender offer;
- purchases as the result of the exercise of another person's put right; and
- other transactions.³²

These disclosure requirements apply to foreign private issuers as well as to domestic issuers, including small business issuers and their affiliated purchasers. "Offshore" purchases by foreign private issuers are covered by these disclosure requirements.

The Multi-Tiered System

As in other contexts under the Federal securities laws, the SEC has created a multi-tiered regulation under Rule 10b-18. Depending upon the ADTV and public float value for their securities and the markets in which their securities are traded, issuers are treated differently under Rule 10b-18.

Implications for companies whose common stock is not listed on a stock exchange or traded on NASDAQ. The one block a week volume alternative provides some relief for companies with securities quoted on the Over-the-Counter Bulletin Board or in the "Pink Sheets" or which have lower ADTV or public float value. However, the 25% ADTV condition for the remainder of the week still may present problems for these companies.

Also, as discussed above, securities ("other securities") that are not "reported securities," which may be the case with some smaller issuers, by SEC staff interpretation, as confirmed in the Adopting Release, are not subject to the timing conditions of Rule 10b-18.

Importance to Companies; Their Brokers; and Their Counsel

Importance to companies and their counsel. Due to the complexity and technical provisions of Rule 10b-18, a company must rely, to an extent, on its broker to assure compliance with the safe harbor. Since many of the provisions of the Rule are highly complex and technical, as a practical matter, only a market professional who deals with them frequently may be in a position to understand them in practice. But all brokers cannot expect to master the provisions of the Rule. Moreover, the responsibility to assure compliance with the safe harbor primarily is that of the issuer; not its broker. Accordingly, to better serve their clients, both outside and inside counsel may wish to have at least a working knowledge of the Rule.

Possible internal procedures. Repurchase programs should be approved by the issuer's board of directors, particularly since state corporate laws may impose restrictions on issuer repurchases of their securities.³³ Another possible procedure

³¹ For purposes of these disclosure requirements, the term "equity security" is defined in section 3(a)(11) of the Exchange Act; not Rule 10b-18. Under Section 3(a)(11), the term "equity security" includes security futures on a stock, convertible securities and warrants and other rights. Thus, the disclosure requirements apply to a much broader range of securities than does Rule 10b-18. Also, purchases by affiliated purchasers, even if not for the account of the issuer, must be reported in the table.

³² The SEC also considered whether to require disclosure of this information more frequently than quarterly or annually but determined not to require such more frequent reporting.

³³ See, for example, Delaware General Corporation Law, Section 160 (restrictions on repurchase of shares); Section 174 (liability of directors for authorizing unlawful repurchases).

to assure that a company's broker complies with the safe harbor provisions is for the company to provide the broker written instructions as to how the repurchase transactions are to be conducted. These instructions, which could closely track the principal provisions of the Rule, can have the benefit of avoiding misunderstandings and possibly protecting the company if the broker makes a mistake. Written instructions also can identify those who the company has authorized to give instructions to the broker and the mechanisms for suspending the repurchase program when appropriate. For example, the company may want to suspend a repurchase program when a major unannounced negotiation or other major event is taking place since, as indicated above in this client alert, Rule 10b-18 does not provide a safe harbor under the general anti-fraud and insider trading provisions of Rule 10b-5.

Importance to brokers. Brokers should be familiar with the provisions of the safe harbor in order to be able to effect repurchases in compliance with the law and to satisfy their obligations to their clients.

Application to Foreign Companies

The safe harbor. The safe harbor is available to foreign companies. However, the SEC has confirmed in the Adopting Release that a foreign company can only look to the trading volume in U.S. securities markets, including the trading volume in ADRs, to determine compliance with the volume restrictions on their U.S. transactions under the Rule.

The new disclosure requirements are applied to foreign companies required to file reports with the SEC on Form 20-F. The disclosure relates to securities in ordinary share form, including, ADRs, and prices should be reported in the currency used in the company's primary financial statements.

Conclusion

Companies may desire to repurchase their shares for many purposes — to acquire treasury shares, to fund employee equity compensation plans or for other purposes; to support their stock in times of market stress; or to provide some benefits to their stockholders by using cash not needed for other purposes. Rule 10b-18, as amended, with all its complexity, is a useful safe harbor for avoiding charges of manipulative conduct in connection with these repurchases.

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