

SEC Adopts Final Rules Affecting Issuer Stock Repurchases

On November 10, 2003, the SEC approved new rules that require disclosure on a periodic basis all of repurchases by an issuer of its equity securities, whether made in the open market or in private transactions.¹ The new rules apply to public companies, foreign private issuers, and closed-end mutual funds.

The SEC also approved amendments to Rule 10b-18 under the Securities Exchange Act of 1934 (the “Act”), the safe harbor from the Act’s anti-manipulation rules for a company’s repurchases of its own securities.

Disclosure of Stock Repurchases

To enhance the transparency of an issuer’s stock repurchases, the SEC adopted new requirements for periodic disclosure of all issuer repurchases of its equity securities that are registered under Section 12 of the Act, whether such purchases are made in the open market or in privately negotiated transactions. The SEC has added Item 703 to regulation S-K, Item 2(e) to Forms 10-Q and 10-QSB, Item 5 (c) to Forms 10-K and 10-KSB, and Item 8 to Form N-CSR (filed semi-annually for closed-end mutual funds)² to require disclosure in tabular form of the following information:

- On a monthly basis,
 - the total number of shares or units purchased during the covered quarter (the fourth quarter in the case of the 10-K/10-KSB),
 - the average price per share paid;
 - the number of shares or units purchased as part of a publicly announced repurchase plan or program, and
 - the maximum number (or approximate dollar value) that may yet be purchased pursuant to such plan or program;
- In a footnote to the table, disclosure of the principal terms of each publicly announced repurchase plan or program, including
 - its announcement date,

¹ Release Nos. 33-8335 (Nov. 10, 2003) is available at <http://www.sec.gov/rules/final/33-8335.htm>.

² New Item 8 will not replace or otherwise modify a close-end fund’s current repurchase disclosure requirements on Form N-SAR. The SEC has, however, eliminated the former requirement for closed-end funds to disclose information regarding privately negotiated repurchases of their securities on Form N-23C-1.

- approved program size,
- any expiration date,
- 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;
- Also in footnote disclosure, a brief description of purchases made other than under a publicly-announced plan or program
 - For example, open market and privately negotiated purchases, issuer tender offers, and purchases upon exercise by a third party of put rights.

Foreign Private Issuers. New Item 15(e) to Form 20-F requires tabular presentation of the same information. A foreign private issuer that has securities registered under Section 12 of the Act will be required to disclose repurchases of its securities in its annual report on Form 20-F. The disclosure provided should relate to the issuer's securities in ordinary share form, whether the issuer has repurchased the shares themselves or depositary receipts that represent the shares. The price data and other data should be based on the currency used in the issuer's primary financial statements.

Amendments to Rule 10b-18

Because a company's share repurchases have a tendency to influence the market price for that company's securities, they may raise concerns under the anti-manipulation provisions of the Act. In 1982, the SEC adopted Rule 10b-18 to provide a safe harbor for bids for and purchases of an issuer's common stock made by the issuer itself or affiliated purchasers³ if specified manner, time, price and volume conditions are met. Rule 10b-18 is a day-by-day safe harbor, so that purchases on any given day must meet the conditions of the rule for that day's purchases to qualify for the safe harbor.

- Manner of Purchase Condition. Issuers must use a single broker or dealer on any day that it bids for or purchases its common stock.
 - Because Rule 10b-18 only applies to purchases solicited by or on behalf of an issuer, an issuer or affiliated purchaser may purchase shares from more than one broker or dealer if the issuer or an affiliated purchaser does not solicit the transaction.

³ The amended Rule defines an affiliated purchaser of the issuer as a person acting in concert directly or indirectly with the issuer for the purpose of acquiring the issuer's securities, and any affiliate that, directly or indirectly, controls the issuer's Rule 10b-18 purchases, or whose purchases are controlled by, or are under common control with, those of the issuer. Under the Rule, the term "affiliated purchaser" does not include a broker, dealer, or other person who solely effects Rule 10b-18 purchases on behalf of the issuer (and for its account). While the literal terms of the Rule could be read to apply to all directors, including outside directors, the release states that an officer or director of the issuer would not be considered an "affiliated purchaser" solely by his participating in the decision to authorize the issuer to effect Rule 10b-18 purchases.

- Timing Condition. Previously, no Rule 10b-18 purchase could be made as the opening transaction or during the last 30 minutes of trading. Under the amended Rule, issuers of more liquid securities (i.e., with an ADTV⁴ of at least \$1 million and public float of at least \$150 million) can continue to bid for or purchase their securities up to 10 minutes prior to the scheduled close of trading.
 - After-Hours Trading. The amended Rule also extends the safe harbor to issuer repurchases effected after-hours (while the consolidated system is still open) and at prices that do not exceed the lower of the closing price of the primary trading session in the principal market for the security and any lower bids or sale prices subsequently reported in the consolidated system by other markets.
 - For after-hours repurchases, the issuer is permitted to use a different broker or dealer than it used during normal trading hours. Additionally, the amended Rule precludes the issuer from effecting a Rule 10b-18 purchase as the opening transaction of the after-hours trading session, but permits repurchases until the termination of the period in which last sale prices are reported in the consolidated system. The Rule's volume limitation carries over from the regular trading session.
- Price Condition. Rule 10b-18 limits the price an issuer is permitted to bid or pay for its stock. Under the previous Rule, that limitation varied depending on where the security was traded. The amended Rule applies a uniform price condition that repurchases be effected at a price not exceeding the higher of the highest independent bid or the last independent transaction price quoted or reported in the consolidated system.
 - For securities not quoted or reported in the consolidated system, the purchase price cannot exceed the higher of the highest independent bid or the last independent transaction price displayed and disseminated on any national securities exchange or on any inter-dealer quotation system displaying at least two priced quotations for the security.
 - For all other securities, the price cannot exceed the highest independent bid obtained from three independent dealers.
- Volume Condition. The previous Rule had a volume condition limiting an issuer to daily purchases of up to 25 percent of the stock's ADTV. However, this volume limitation (and the calculation of ADTV) did not include any "block" purchases by the issuer.⁵ As a result, an issuer could make unlimited block purchases under the previous rule.

⁴ ADTV is defined as 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." Note that this definition is different from the definition of "ADTV" in Regulation M.

⁵ A "block" purchase is defined as a block of securities that either: (i) had at least a \$200,000 purchase price; (ii) was at least 5,000 shares of at least a \$50,000 purchase price; or (iii) was at least 20 round lots totaling at least 150 percent of the security's ADTV or, if trading volume data was unavailable, totaling at least 0.1 percent of the outstanding shares of the security, exclusive of any shares owned by any affiliate.

- Because block purchases today represent as much as one-half of all market activity, the SEC concluded that block purchases are no longer the exception, and have a substantial impact on market prices with the potential for manipulative abuse. As a result, the amended Rule eliminates the block purchase exclusion, and now includes block purchases in both the 25 percent volume limitation and the ADTV calculation.
- To accommodate issuers of thinly traded securities, the amended Rule permits an issuer to make one block purchase per week provided the issuer makes no other 10b-18 purchases on that day. Under this alternative, once each week an issuer may make one block purchase of its common stock *in lieu of* relying on the 25% volume limitation for that day. However, shares purchased by the issuer relying on this alternative may not be included when calculating a security's ADTV under the Rule.
- Market-wide Trading Suspension Alternative. Under the previous Rule, the timing conditions did not apply immediately following the lifting of a market-wide trading suspension. The amended Rule further broadens the safe harbor during such time by increasing the volume limitation to 100 percent, up from the current 25 percent, of the security's ADTV, in order to facilitate liquidity during certain rare periods of severe market decline.⁶

Limitations on Use of the Rule 10b-18 Safe Harbor in Connection with Merger, Acquisition and Similar Transactions

Previously, the safe harbor provided by Rule 10b-18 did not cover purchases made pursuant to a “merger, acquisition, or similar transaction involving a recapitalization.” Concerned that issuers have a strong incentive to support or raise the price of their stock to facilitate such a transaction once it is announced, the SEC amended the definition of “Rule 10b-18 purchase,” to clarify that purchases that are 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 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 transactions) are not covered by Rule 10b-18's safe harbor.

- Regulation M restricts bids for and purchases of an issuer's securities by the issuer or an affiliated purchaser if the issuer is involved in a distribution involving a merger, acquisition, or exchange offer (for example, a stock-for-stock merger) from the date the proxy solicitation or offering materials are first sent to shareholders, until the time of the shareholder vote or the expiration of the offer). The “merger exclusion” from Rule 10b-18's safe harbor begins at the “time of public announcement,” which is much earlier than the beginning of the restricted period under Regulation M. As a result, issuers that engage in multiple, overlapping transactions may be precluded from relying on Rule 10b-18's safe harbor for extended periods of time.

⁶ The SEC will continue to view market situations, other than market-wide trading suspensions, on a case-by-case basis, relying on its emergency and exemptive authority in Sections 12(k)(2) and 36 of the Exchange Act, as it did following the reopening of the markets after September 11, 2001.

- Although issuers have the flexibility to repurchase shares outside of the Rule 10b-18 safe harbor, many issuers are reluctant to do so.
- The SEC provided three exceptions to this merger exclusion from Rule 10b-18's safe harbor for:
 - Transactions in which the only consideration is cash and there is no valuation period.
 - Ordinary Rule 10b-18 purchases effected after the announcement of a merger or covered transaction (subject to Regulation M's restriction period and any other applicable restrictions) so long as the issuer's Rule 10b-18 purchases on any single day do not exceed the lesser of 25% of the security's average four-week ADTV, or the issuer's average daily Rule 10b-18 purchases during the full three calendar months preceding the date of the announcement of the merger or other covered transaction.⁷
 - Purchases made pursuant to the amended block purchase exception (subject to Regulation M's restriction period and any other applicable restrictions), provided the issuer does not exceed the average size and frequency of such block purchases during the three full calendar months preceding the date of the announcement of the merger or other covered transaction.⁸

Compliance Dates

The new tabular disclosure required by new Item 2(e) of Forms 10-Q and 10-QSB and new Item 5(c) of Forms 10-K and 10-KSB must appear in reports filed for periods ending on or after March 15, 2004. The disclosure required by new Item 16E of Form 20-F must appear in Form 20-F reports filed for fiscal years ending on or after December 15, 2004.

The repurchase disclosure required by new Item 8 and Item 10(a)(3) of Form N-CSR must appear in reports filed on this form by registered closed-end management investment companies for periods ending on or after June 15, 2004. A registered closed-end management investment company need not file reports on Form N-23C-1 with respect to any repurchases during any calendar month following June 2004.

The Rule 10b-18 amendments become effective December 17, 2003.

⁷ For example, if the daily average amount of the issuer's Rule 10b-18 purchases over the course of the three full calendar months prior to the merger announcement was 10,000 shares per day, and 25% of the security's four-week ADTV is 20,000 shares per day, then the issuer could purchase up to 10,000 shares per day during the post-announcement period. Accordingly, if the issuer did not make any Rule 10b-18 purchases during this three-month period, it would not be permitted to make any Rule 10b-18 purchases during the post-announcement period.

⁸ For example, if a thinly traded issuer purchased three blocks over the course of the three full calendar months prior to a merger announcement (an average of one block per month) and the average block size was 7,800 shares, then the issuer could purchase a block no larger than 7,800 shares each month during the post-announcement period (subject to other applicable restrictions). If the issuer did not make any block purchases under the amended block exception during that three-month period, the issuer could not utilize the amended block exception during the post-announcement period.

Contact Information

If you have any questions or would like to learn more about these rules, please contact your usual legal advisor at Ropes & Gray.