

Client Alert

Latham & Watkins Corporate Department

Proposed Amendments to Rule 10b-18 Under the Exchange Act

On January 26, 2010, the US Securities and Exchange Commission (SEC) published several proposed amendments to Rule 10b-18 under the Securities Exchange Act of 1934 (Exchange Act).¹ According to the SEC's release (the Proposing Release), the amendments are "intended to clarify and modernize" Rule 10b-18's safe harbor provisions, which protect issuers that purchase securities in accordance with the Rule's manner, timing, price and volume conditions from "manipulation liability" under Section 9(a)(2) of the Exchange Act and Rule 10b-5 under the Exchange Act.²

The proposed amendments would:

- modify Rule 10b-18's timing condition to preclude opening purchases in the principal market for a security even if those purchases were effected after another purchase has been reported in the consolidated system;³
- except purchases made on a volume-weighted average price (VWAP) basis from the price condition to Rule 10b-18's safe harbor;⁴
- limit the scope of Rule 10b-18's general disqualification provision when an issuer's purchase order is entered in accordance with Rule 10b-18's manner, timing, price and volume conditions, but is executed in violation of Rule 10b-18's price condition because of "flickering" quotations;⁵

- extend the time during which Rule 10b-18's safe harbor provision is unavailable to a special purpose acquisition company (a SPAC) undertaking an acquisition;⁶ and
- update certain definitional provisions.⁷

The SEC has asked for comments on the proposed amendments on or before March 1, 2010.

The VWAP Exception

The most notable proposed amendment to Rule 10b-18 would except certain purchases effected on a VWAP basis from the price condition to Rule 10b-18's safe harbor. In its current form, Rule 10b-18's safe harbor is available only for purchases effected at a price that is no higher than the maximum of the highest independent bid or the last independent transaction price quoted or reported in the consolidated system at the time the purchase is effected.⁸

To "provide issuers with additional flexibility,"⁹ while retaining Rule 10b-18's core anti-manipulation protections, the proposed amendments would except purchases made on a VWAP basis from Rule 10b-18's price condition if:

- the securities purchased are "actively traded securities" (as defined under Rule 101(c)(1) of Regulation M);¹⁰

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- the purchaser enters into the VWAP-based trade before the open of the regular trading session;¹¹
- the quantity of securities purchased on a given day does not exceed 10 percent (as opposed to 25 percent, the current volume condition) of the ADTV¹² for such day;¹³ and
- the purchase is not effected “for the purpose of creating actual, or apparent, active trading in or otherwise affecting the price of any security.”¹⁴

In addition, the price paid by the purchaser must be set in accordance with a technical definition of the VWAP set out in the Proposing Release. In particular, the price paid per share on a given day must equal the volume-weighted average price per share of every regular way trade of the relevant security reported in the consolidated trading system and effected in accordance with Rule 10b-18’s timing and price conditions during the primary trading session for such day.¹⁵

Finally, to elicit public comment on the proposed VWAP exception, the SEC posed a series of questions regarding the scope of, and conditions to, the exception. In particular, the SEC asked whether, among other things, the VWAP exception should be extended to “intra-day VWAPs,” back-up documentation should be required or a distinction should be made between “automatically” and “manually” executed VWAP purchases.¹⁶

Further Expansion of the Pricing Exception?

Although the proposed amendments included in the Proposing Release excepted only VWAP-based purchases from Rule 10b-18’s price condition, the SEC also stated that it was considering whether other “passive” or “independently-derived” pricing mechanisms should enjoy similar exceptions.¹⁷ In particular, the SEC pointed out that because passive trades

often have little price discovery value and are unlikely to create the types of price manipulation that Rule 10b-18 was designed to prevent, it might be appropriate to exempt additional types of electronic trades effected at externally derived prices in which neither the purchasers nor the sellers were assured of receiving a matching order.¹⁸

Other Open Issues

In addition to seeking comment on each of the proposed amendments, the SEC also raised a number of questions regarding Rule 10b-18’s safe harbor more generally, including the following:

- If the exception to Rule 10b-18’s price condition is extended to include passive or externally determined prices, what other conditions should apply?
- Is Rule 10b-18’s 25 percent ADTV limitation appropriate?
- Should Rule 10b-18’s safe harbor be available to an issuer when its insiders are selling shares of its stock?
- Should Rule 10b-18’s safe harbor be extended to include purchases of securities other than common stock?
- Should issuers and broker-dealers be permitted to enjoy Rule 10b-18’s safe harbor when they engage in accelerated share repurchases or forward contracts and, if so, what additional manipulative concerns are raised by such novel transactions?

Conclusion

Given the breadth of the SEC’s inquiries, and the SEC’s stated desire to “clarify and modernize” Rule 10b-18, it is possible that the SEC will ultimately propose additional amendments to Rule 10b-18. We note, however, that, here, the comment period is relatively brief (34 days), which may pose some challenges for commentators who wish to make more comprehensive suggestions about the Rule.

Endnotes

- ¹ The SEC's release is available at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.
- ² Release No. 34-61414 at 1, 5-7 (January 26, 2010) (the Proposing Release), is available at <http://www.sec.gov/rules/proposed/2010/34-61414.pdf>.
- ³ Proposed Rule 10b-18(b)(2)(i).
- ⁴ Proposed Rule 10b-18(a)(14).
- ⁵ Proposed Preliminary Note No. 1 to Rule 10b-18; Proposed Rule 10b-18(d)(2).
- ⁶ Proposed Rule 10b-18(a)(13)(iv).
- ⁷ Proposing Release at 27-29.
- ⁸ 17 CFR 240.10b-18(b)(3).
- ⁹ See Proposing Release at 16.
- ¹⁰ Proposed Rule 10b-18(a)(14)(i). Under Regulation M, a security is actively traded if its worldwide average daily trading volume is at least \$1 million and its public float is at least \$150 million. 17 CFR 242.101(c)(1).
- ¹¹ Proposed Rule 10b-18(a)(14)(ii).
- ¹² Under Rule 10b-18, the "ADTV" for a security for a day means the average daily trading volume for that security reported during the four calendar weeks immediately preceding the week in which such day falls. 17 CFR 240.10b-18(a)(1).
- ¹³ Proposed Rule 10b-18(a)(iv).
- ¹⁴ Proposed Rule 10b-18(a)(v).
- ¹⁵ Proposed Rule 10b-18(a)(iii), (vi).
- ¹⁶ See Proposing Release at 21-23.
- ¹⁷ Proposing Release at 23.
- ¹⁸ Proposing Release at 24.

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