REGULATION
OF
STOCK REPURCHASE PROGRAMS
UNDER
THE FEDERAL SECURITIES LAWS

Many public companies employ stock repurchase programs to increase shareholder value at times when their outstanding securities are perceived to be underpriced or to minimize the dilution caused by the use of stock in acquisitions or for employee plans. Issuers must design repurchase programs to comply with a number of potentially applicable provisions contained in the federal securities laws. The purpose of this memorandum is to outline these provisions very briefly and to serve as a basis for additional discussions with legal counsel.

In addition to the federal securities law provisions discussed in this memorandum, applicable state corporate and securities laws and the issuer's own charter documents and contractual arrangements (including, for example, bank credit facilities) must be reviewed before beginning any stock repurchase program to determine additional restrictions. Stock repurchases are often treated as the equivalent of dividend distributions under state corporate laws, charter provisions and loan and other financing agreements which restrict dividend distributions. Stock repurchase programs may also raise important accounting issues, and consequently, issuers should consult their public accountants as well as their legal counsel before beginning a stock repurchase program.

In recent years, issuers and investment bankers have developed and implemented a variety of techniques to accelerate buy-backs or hedge market risk during repurchase programs. The special legal issues posed under federal securities laws by accelerated stock buy-back transactions or by use of puts, calls, costless equity collars or comparable devices are beyond the scope of this general memorandum.

Market Manipulation Safe Harbor: Rule 10b-18

Stock purchases by an issuer and its affiliates are subject to the anti-manipulation provisions of Sections 9(a)(2) and 10(b) of the Securities Exchange Act of 1934. These provisions make it unlawful (1) to manipulate prices of a security by creating actual or apparent trading in such security or by raising or depressing the price of such security, and (2) to use any manipulative or deceptive device or contrivance in contravention of SEC rules in connection with the purchase or sale of any security.

Rule 10b-18 under the Exchange Act provides a nonexclusive safe harbor from the provisions of Sections 9(a)(2) and 10(b) for open market bids and purchases of stock by issuers and persons considered to be "affiliated purchasers" insofar as such bids or purchases might be deemed unlawfully manipulative solely by reason of their time, price or amount or the number of brokers or dealers used. An "affiliated purchaser" under Rule 10b-18 is a person acting in concert with the issuer for the purpose of acquiring the issuer's securities, or is an affiliate that, directly or indirectly, controls the issuer's purchases, or whose purchases are controlled by, or under common control with, those of the issuer. This definition will normally cover a parent

company of the issuer as well as officers and directors having responsibility for the issuer's purchases.

Rule 10b-18 does not apply to tender offers, purchases by an employee benefit plan effected by an independent agent and certain other purchases. The rule is not a safe harbor from violations of Rule 102 of Regulation M under the Exchange Act (which restricts purchases of securities that are the subject of a distribution) or violations of Section 10(b) and Rule 10b-5 that entail conduct other than manipulation solely by reason of the time, price or amount of repurchases or the number of brokers or dealers used. For example, if an issuer or affiliated purchaser engages in repurchases while aware of material nonpublic information of a favorable nature there may be a violation of Section 10(b) and Rule 10b-5, notwithstanding compliance with Rule 10b-18.

In order to take advantage of the safe harbor provided by Rule 10b-18, an issuer and its affiliated purchasers must comply with all of the conditions of the rule:

- <u>One Broker or Dealer Per Day</u>. All Rule 10b-18 bids or purchases on behalf of the issuer or any affiliated purchaser must be made from or through a single broker or dealer on any single day. All such bids or purchases made on behalf of more than one affiliated purchaser, or the issuer and one or more affiliated purchasers, on a single day, must similarly be made from or through a single broker or dealer.

  Because of the complexity of complying with Rule 10b-18, issuers and affiliated purchasers contemplating a market repurchase program normally make prior arrangements with one broker or dealer having extensive experience in such programs to carry out the entire program on their behalf.

- <u>Timing of Purchase</u>. If the security is traded on a national exchange or the Nasdaq National Market, the purchase must not constitute the day's opening transaction for the security. Such a security also may not be purchased during the last half hour of scheduled trading on the exchange that is its principal market or on which the purchase is actually made or during the last half hour before termination of the period in which last sale prices are reported on the Nasdaq National Market.

  For a Nasdaq security (other than a Nasdaq National Market security), purchases may be made only if there exists a current independent bid for the security as reported in Level 2 of Nasdaq.

  To help improve liquidity immediately following a market-wide trading suspension, the safe harbor is available without compliance with these timing restrictions either (a) from the reopening of trading until the scheduled close of trading on the same day as the suspension or (b) at the opening of trading on the next trading day if the market did not reopen on the day of the suspension.

  For an over-the-counter security not reported on Nasdaq, Rule 10b-18 does not impose any timing restrictions.

- Price of Purchase. If the security is traded on a national exchange or the Nasdaq National Market, the price at which an issuer or affiliate may purchase or bid on securities through a broker or dealer must not exceed the higher of the current independent bid quotation or the last independent sale price of the security.

  Bids and purchases of a Nasdaq security (other than a Nasdaq National Market security) may only be made through a broker or dealer at a price that does not exceed the lowest current independent offer quotation reported in Level 2 of Nasdaq.

  For an over-the-counter security not reported on Nasdaq, bids and purchases may not be made through a broker or dealer at a price that is higher than the lowest current independent offer quotation determined on the basis of reasonable inquiry.

  For purposes of Rule 10b-18, the "purchase price" of a security excludes commissions and any commission equivalent, mark-up or differential paid to a dealer if the security is traded on a national exchange or the Nasdaq National Market. For a Nasdaq security (other than a Nasdaq National Market security) or an over-the-counter security not reported on Nasdaq, "purchase price" excludes commissions but includes any commission equivalent, mark-up or differential paid to a dealer.

- Volume of Purchases. If the security is traded on a national exchange or the Nasdaq National Market or otherwise quoted on Nasdaq, the issuer and its affiliated purchasers are permitted to make daily purchases of up to 25% of the average daily trading volume of the security for the four calendar weeks preceding the Rule 10b-18 purchase. "Block purchases" (as defined in the rule) and private transactions not effected through a broker or dealer are not required to be included in computing the 25% daily volume limitation.

  With regard to over-the-counter securities not reported on Nasdaq, daily purchases may be made of up to one round lot (100 shares or other customary unit of trading for a security) or an amount which, when added to Rule 10b-18 purchases made during the preceding five business days by the issuer and affiliated purchasers, does not exceed 1/20th of 1% of all outstanding shares owned by nonaffiliates of the issuer, plus unlimited block purchases and private transactions not effected through a broker or dealer.

Complying with the Rule 10b-18 conditions requires an issuer to identify all its affiliated purchasers and coordinate all their open market bids and purchases with its own. The conditions of Rule 10b-18 are complex, and the rule itself, rather than these summaries, should be consulted for technical compliance.

Insider Trading Liability and Disclosure Issues: Rule 10b-5

While Rule 10b-18 provides a safe harbor against stock repurchase programs being viewed as manipulative, it does not insulate repurchases from insider trading liability. Section 10(b) of the Exchange Act and Rule 10b-5 prohibit material misstatements or material omissions of fact in connection with the purchase or sale of any security. Issuers and affiliates are generally deemed to have an affirmative duty under Section 10(b) and Rule 10b-5 to disclose all

material nonpublic information concerning the issuer when trading in the issuer's securities. Section 10(b) and Rule 10b-5 may impose liability on issuers and affiliates engaged in a repurchase program at a time when there exists material nonpublic information of a favorable nature concerning the issuer.

Information is generally deemed "material" under the federal securities laws if there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. The contours of the affirmative duty imposed by Section 10(b) and Rule 10b-5 are somewhat unclear and the concept of "materiality" is subject to interpretation on a case-by-case basis. Issuers and insiders generally should refrain from repurchases (or from implementing a binding contract, instruction or written plan to repurchase) during periods when significant information regarding matters such as proposed acquisitions, dispositions or mergers, changes in dividend rates or earnings, significant new contracts, new products and marketing plans, financial results and forecasts, additional financing or capital investment plans or changes in management or control has not been fully disseminated to the investing public.

The fact that the issuer is planning a repurchase program of its own stock should generally be viewed as material and be disclosed through a press release. Such a press release may include: (1) the number or aggregate dollar amount of shares to be purchased; (2) the method of repurchase (*i.e.*, open market transactions, block transactions, privately negotiated transactions, tender offer or accelerated stock buy-back transactions); (3) whether purchases will be made from any officer, director or control person; (4) the source of funding for the repurchase program; (5) any arrangement with any person for the purchase of securities; (6) the period during which such purchases may be made; (7) the purposes for which the repurchased securities will be used (*e.g.*, to meet obligations under employee stock plans); and (8) a statement that the purchases are to be made subject to restrictions relating to volume, price and timing in an effort to minimize the impact of the purchases upon the market for the securities.

Use of Binding Contracts, Instructions and Written Plans: Rule 10b5-1

Rule 10b5-1 under the Exchange Act provides important flexibility for issuers to use qualifying contracts, instructions or plans to carry out repurchase programs despite the inevitable ebb and flow of material nonpublic information. Rule 10b5-1 explicitly provides that an individual or entity buying or selling securities while aware of material nonpublic information does not violate Rule 10b-5 if the buying or selling is in conformity with a binding contract, instruction or written plan put into place at a time when the trader was not aware of such information.

The liability avoidance provisions of Rule 10b5-1 are affirmative defenses. If the government can prove an individual or entity was aware of material nonpublic information at the time of a purchase or sale, the burden of proving that the trading was pursuant to an adequate contract, instruction or written plan will be on the trader. Compliance must be well documented and capable of proof in court.

Depending upon the issuer's unique objectives, it may be possible to structure a stock repurchase program that complies with Rule 10b-18 while also providing the issuer the affirmative defenses of Rule 10b5-1. For example, some issuers may want to conduct their

repurchase program through a prearranged written formula plan. Other issuers may prefer to delegate actual trading decisions, within certain defined parameters, to a broker or other person over whom the issuer does not exercise influence. Still other issuers may establish information barriers using policies and procedures that prevent the flow of material nonpublic information to the individual making the decision on its behalf to repurchase stock.

Issuers should exercise great care, however, in relying on new Rule 10b5-1 for several reasons:

- In order to meet the requirements of Rule 10b5-1, binding contracts, instructions and written plans must lock in the amount, price and dates of future trades or delegate discretion for determining amount, price and dates to a third-party precisely as provided under the rule.

- The ability to modify provisions once locked in is limited, and modification or termination of arrangements may be very risky.

- The person to whom authority is delegated to make trading decisions or the individual making the investment decision to sell securities on the issuer's behalf must not be aware of material nonpublic information when trading in the issuer's stock.

For these reasons, issuer Rule 10b5-1 plans have not yet come into common usage. A more detailed discussion of the protections provided by Rule 10b5-1 is contained in our memorandum entitled "SEC Rule 10b5-1 Affords New Protection For Issuer Repurchase Programs and Trading by Insiders" (October 23, 2000).

Purchases During a Distribution: Regulation M

Regulation M (Rules 100 through 105) under the Exchange Act is designed to prevent manipulative activities by participants in a distribution of securities. Rule 102 of Regulation M prohibits an issuer and affiliated purchasers from bidding for or purchasing any security of the issuer (or any reference security) that is the subject of a distribution during a defined restricted period. A "distribution" under Regulation M is broadly defined to include "an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods." The term "reference security" includes any security into which the subject security may be converted, exchanged or exercised or which, under the terms of the subject security, may determine the subject security's value in whole or in part.

The definition of "affiliated purchaser" is basically the same under Regulation M as under Rule 10b-18, except that there is no provision in Regulation M expressly negating inclusion of officers and directors solely by reason of their participation in the decision to authorize the issuer's purchases.

The prohibitions in Rule 102 are complex and include a number of important exceptions. The most important provisions for an issuer engaged in a repurchase program are those determining the "restricted period" during which repurchases must be suspended by reason of a distribution. The restricted period for any security with an average daily trading volume (as

defined in Regulation M) of $100,000 or more of an issuer that has common equity with a public float value of $25 million or more begins one business day before pricing of the distribution. For other securities, the restricted period begins five business days before pricing. In the case of a distribution involving a merger, acquisition or exchange offer, the restricted period begins on the day the proxy or offer materials are first disseminated. The restricted period ends upon completion of the distribution.

Issuers contemplating a market repurchase program should carefully review whether they are engaged in, or anticipate engaging in, any course of action that may be deemed to be a distribution under the broad definition of Regulation M. Rule 102 is expressly inapplicable to distributions pursuant to employee benefit plans, DRIPs or interest reinvestment plans.

Going Private Regulation: Rule 13e-3

Issuers contemplating a stock repurchase program must also be careful not to run afoul of the SEC's going private regulation in Rule 13e-3. Rule 13e-3 makes it a fraudulent, deceptive or manipulative practice for an issuer or affiliate to engage, directly or indirectly, in a "Rule 13e-3 transaction" unless certain required disclosures are disseminated to securityholders prior to such transaction. Required disclosures include the identity of the parties, terms of the transaction, plans of the issuer or affiliate, source of funds, purpose of the transaction, fairness of the transaction and other information.

A "Rule 13e-3 transaction" is defined, in relevant part, as the purchase of any equity security by the issuer, or by an affiliate of the issuer, which has either a reasonable likelihood or a purpose of causing (1) any class of registered equity securities to be held of record by less than 300 persons, or (2) any class of equity securities to be delisted from an exchange or Nasdaq ineligible.

Issuers with relatively small public distribution of shares, relatively low trading volume or relatively few securityholders of record must carefully plan market repurchases in order to avoid a going private transaction and impairment of the market for the issuer's securities.

Tender Offer Regulations

Issuers contemplating a stock repurchase program must also be careful not to run afoul of the SEC's tender offer regulations. The rules governing tender offers reside primarily in Regulation 13E (covering issuer tender offers by public companies), Regulation 14D (covering certain third-party tender offers for equity securities of public companies) and Regulation 14E (covering all tender offers). The rules dictate filing, information delivery and offer dissemination requirements and also prescribe minimum time requirements for the offer, withdrawal and proration periods. Regulation 13E and Regulation 14D also contain "all-holders" and "best-price" provisions requiring that tender offers be open to all holders of the class and that the consideration paid to any holder in an offer be the highest consideration paid to any other holder in the offer.

SEC regulations do not define what constitutes a tender offer. Under applicable case authority, a normal repurchase program complying with Rule 10b-18 and effected in the open market at various prices and without special solicitation, will not be deemed a tender offer, at

least if it is conducted during a period when the issuer is not, and has not recently been, the subject of a takeover attempt. Issuers contemplating a market repurchase program should carefully review applicability of tender offer regulations with legal counsel before beginning a repurchase program.

Beneficial Ownership Reporting: Regulation 13D-G

Regulation 13D-G under the Exchange Act requires any person who acquires equity securities of a class registered under the Exchange Act and who, after such acquisition, owns in excess of 5% of the outstanding equity securities of such class, to report such beneficial ownership by filing a Schedule 13D with the SEC and the issuer within 10 days of such acquisition. An amended Schedule 13D must be filed promptly following any material increase or decrease in the percentage of the class beneficially owned (a 1% increase or decrease in ownership being presumed to be "material" for such purposes). Information required to be disclosed in Schedule 13D includes whether the filer owns the shares outright or as part of a group, the source of financing for the share acquisition and the purpose of the acquisition.

Certain institutional investors (including broker-dealers, banks, insurance companies, investment companies and investment advisers) and "passive investors" (those owning beneficially less than 20% of the outstanding shares of the class and able to certify that they do not intend to effect a change of control in the issuer) may file the less burdensome Schedule 13G instead of Schedule 13D and may generally report subsequent changes in ownership only once per year.

Regulation 13D-G also requires any person who owns in excess of 5% of a class of equity securities registered under the Exchange Act as of December 31 of any year, but who was not required to file a Schedule 13D or 13G in connection with acquisition of such securities (because, for example, such securities were acquired before the class became so registered), to report such beneficial ownership by filing a Schedule 13G with the SEC and the issuer within 45 days of the first December 31 on which such ownership exists. An amended Schedule 13G must be filed within 45 days of the end of any calendar year in which a change in the information reported in the original filing occurs (unless such change is solely the result of a change in the total number of outstanding securities of the class).

An issuer acquiring its own equity securities is excluded from the provisions of Regulation 13D-G and, consequently, is not required to file any Schedule 13D or 13G. Affiliates of an issuer participating in a stock repurchase program (including a parent company of the issuer), however, are subject to Regulation 13D-G. Management should therefore consider in planning a market repurchase program whether the program will require Schedule 13D or 13G amendments from previous filers or require new filings by persons who have not previously filed.

Short-Swing Profit Rule: Section 16

Section 16(b) of the Exchange Act makes directors, officers and 10% shareholders of any issuer which has a class of equity securities registered under the Exchange Act liable to the issuer for any short-swing profits derived from trading in equity securities of any class of the issuer.

Short-swing profits basically include any profit derived from a purchase and a sale or a sale and a purchase of equity securities of the issuer which occur within less than six months of each other. Section 16(a) requires persons becoming subject to the short-swing profit rule to file reports (on Forms 3, 4 and 5) with the SEC disclosing ownership and changes in ownership of the issuer's equity securities. The rules enacted pursuant to Section 16 exempt various types of transactions from these reporting and liability provisions.

An issuer purchasing its own equity securities is excluded from the provisions of Section 16 of the Exchange Act so long as the securities are acquired for the issuer's own account. Affiliates of an issuer participating in a stock repurchase program (including a parent company of the issuer) may, however, be subject to Section 16. Accordingly, when planning a stock repurchase program, issuers should consider possible Section 16 reporting requirements that may arise for insiders or significant shareholders as a result of the purchases and the reductions in shares outstanding and any potential short-swing profit liability.

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