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The New Rule 10b-18: How the Wachovia Merger Continues to Plague the Future of the Banking Industry

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I. INTRODUCTION

In September of 2001, Wachovia Corporation (Wachovia), of Winston-Salem, North Carolina, and the former First Union Corporation (First Union), of Charlotte, North Carolina, merged to form Wachovia Corporation, N.A., a Charlotte-based financial holding company.\(^1\) For months, the merger appeared unlikely, and was only consummated after the companies fended off a hostile bid from SunTrust Banks, Inc. (SunTrust), of Atlanta, Georgia.\(^2\) To many in the banking industry, the challenge from SunTrust came as no surprise.\(^3\) In fact, the Wachovia-First Union merger became possible only after Wachovia abandoned a December 2000 merger with SunTrust just four days before the two banking giants planned to announce the merger.\(^4\) The December announcement shocked many, because not only did a Wachovia-SunTrust merger appear to be “an almost perfect match,” but SunTrust had agreed to pay a twelve percent premium for Wachovia’s stock, a far more lucrative deal than First Union’s initial offer.\(^5\) What precipitated Wachovia’s balk on the eve of the announcement remains a secret, but many now know that only four months after brushing off SunTrust’s overtures, Wachovia was set to merge with First Union.\(^6\) In short, Wachovia had its chance to merge with SunTrust

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4. See id.
5. See id.
6. Id. One attempt to explain the “December Surprise” has suggested that, “disagreements over asset management were simply the final straw and symptomatic of larger disagreements [between Wachovia and SunTrust]. The Wachovia side felt that the SunTrust executives had proposed a merge of equals but were really
but walked away from the deal at the last minute.\textsuperscript{7} Therefore, when SunTrust returned with an unsolicited bid for Wachovia a few months later, Wachovia and First Union countered with a campaign to save their so-called “merger among equals.”\textsuperscript{8}

The cornerstone of Wachovia’s counter-attack\textsuperscript{9} was a repurchase program\textsuperscript{10} that saw Wachovia purchase $4 million of its own shares, as well as $552 million First Union shares, in the spring of 2001.\textsuperscript{11} During this same season, First Union purchased $67 million of its own shares.\textsuperscript{12} In addition to being significant acquisitions, these repurchases played a major role in determining the outcome of the proposed merger between First Union and Wachovia. For instance, in May of 2001, before First Union and Wachovia commenced the repurchasing campaign, SunTrust’s bid was 16.7% higher than First Union’s.\textsuperscript{13} But as of July 24, 2001, a week before the shareholder vote on the competing proposals and weeks after significant repurchasing activities by both Wachovia and First Union, the spread between the competing bids had fallen
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to a mere six percent in favor of SunTrust.\textsuperscript{14} Thus, the more than $600 million in repurchases of First Union stock during the takeover conflict coincided with an escalation of First Union's share price, thereby narrowing the differential between the competing offers.\textsuperscript{15} The spread between the competing offers proved to be crucial, because the merger deal involved a $14 billion stock swap.\textsuperscript{16} Since the basis of the deal was common stock, the attractiveness of First Union's offer depended on the price of its stock, which rose during the repurchasing period. Therefore, without such significant repurchasing activity, First Union would have been unable to present Wachovia's shareholders with an offer comparable to SunTrust's unsolicited bid.\textsuperscript{17}

In addition to prompting an investigation by the Securities and Exchange Commission (Commission) into the legality of the repurchases,\textsuperscript{18} the actions of Wachovia and First Union also seem to have been a motivating force in prompting the Commission to revise the rule that facilitated these transactions. For instance, the now amended Rule 10b-18 altered the definition of a Rule 10b-18 purchase to exclude repurchases "effected during the period from the time of public announcement of the merger, acquisition, or similar transaction involving a recapitalization, until the completion of such transaction."\textsuperscript{19} First Union initiated the stock repurchasing activities after it had joined with Wachovia in publicly announcing the merger.\textsuperscript{20} As a result, under the new regime, First Union would have been unable to engage in the significant repurchasing activities that allowed its offer to remain

\textsuperscript{14} See id.
\textsuperscript{16} See id.
\textsuperscript{17} See id. During the period when First Union was repurchasing its own stock, Sun Trust was prohibited from taking similar action because attorneys for First Union successfully petitioned the SEC to bar SunTrust from buying its own stock during the proxy solicitation. Thus, value of SunTrust's unsolicited bid remained flat, allowing First Union to close the price differential between the two offers. See Robert Lennon, \textit{The Multitasker}, \textit{AM. LAW.} Apr. 7, 2002, at 80.
\textsuperscript{18} Rothaker, \textit{supra} note 12, at 2D.
\textsuperscript{19} Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,954-55 (Nov. 17, 2003) (to be codified at 17 C.F.R. \textsection 240,10b-18(a)(13)(iv)).
\textsuperscript{20} Rothaker, \textit{supra} note 12, at 2D.
competitive against the SunTrust overture. The Commission’s justification for extending the blackout period to the public announcement of a merger is simple: “Once a merger or acquisition is announced, an issuer has considerable incentive to support or raise the market price of its stock in order to facilitate the merger or acquisition.” In justifying this conclusion, the Commission cites a “recent contested takeover [where] banks repurchased their respective securities in order to boost their stock price to enhance the value of their competing merger proposals.”

Thus, in addition to prompting an SEC investigation, the First Union-Wachovia buyback activities initiated the Commission’s amendment of Rule 10b-18.

Unfortunately, the Commission did not stop with preventing merging parties from using the rule’s safe harbor to avoid charges of manipulation. It went further in tinkering with the rest of the Rule, even though these additional provisions do not aid improper stock price boosting in the context of mergers. Therefore, the amended rule does more than proscribe the behavior of Wachovia and First Union. It eliminates the block exception to the volume condition, thereby favoring large issuers while placing companies whose stock is thinly-traded at a competitive disadvantage.

Since 1982, issuers have been able to make block repurchases of their common stock under the safe harbor of Rule

22. Id.
23. Rothaker, supra note 12.
25. Since repurchases can produce fluctuation in an issuer’s securities, some may claim that the repurchases were effected to manipulate the market price. Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others, 67 Fed. Reg. 77,594, 77,594 (Dec. 18, 2002). As a result, Rule 10b-18 provides a safe harbor for repurchases that satisfy, on a daily basis, the conditions set out in the Rule regarding timing, price, volume and manner conditions. See infra note 41 and accompanying text.
26. The other provisions amended by the Commission include the elimination of the block exception from the volume condition. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. at 64,958-60 (Nov. 17, 2003) (to be codified at 17 C.F.R. § 240.10b-18).
10b-18. In December of 2002, the Commission released a proposal that would erase this “block exception” regulation from the pages of the Code of Federal Regulations. The Commission based its reversal of policy on the presumption that “the block exception may allow issuers to dominate the market for their securities in a way not originally contemplated by the safe harbor.” Thus, the Commission concluded that modern conditions have raised “the possibility that investors could be misled about the integrity of the securities trading market as an independent pricing mechanism.” The Commission followed through on its proposal in December of 2003 when it amended Rule 10b-18 to eliminate the block exception, with one significant caveat that fails to adequately remedy the concerns raised in this note. In addressing these concerns, however, the Commission failed to cite any evidence that the block exception led to market manipulation in the more than twenty years since the safe harbor came into existence.

Due to the burden placed on issuers whose stock is thinly traded and the existence of more reasonable alternatives to the Commission’s Rule, the Commission should either abandon the change or enact one of the proposals suggested herein as a more beneficial alternative to address the Commission’s concerns.

Part II of this article examines the original form of Rule 10b-18 and the conditions an issuer must meet for a repurchase to fall within the confines of the Rule’s safe harbor. Part III considers the Amended Rule, the adverse effects this Rule will have on the banking industry, and various alternatives to the rule.

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29. Id. at 77,600 (emphasis added).
30. Id.
31. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. at 64,960.
32. See infra notes 34-67 and accompanying text.
33. See infra notes 58-136 and accompanying text. Specifically, Part III confines its examination to the block purchase and the volume limitation of the Current and
II. THE ORIGINAL RULE 10B-18

On November 26, 1982, the Commission adopted Rule 10b-18 under the Securities Exchange Act of 1934. The rule provided a safe harbor for companies that wish to repurchase their own stock from investors. Compliance with the rule helped to assure that certain anti-manipulative provisions of federal securities laws, such as Rule 10b-5 and section 9(a)(2) are not violated solely by reason of the volume, price, timing, or manner of the issuer’s repurchases of common stock. Compliance with Rule 10b-18 is voluntary; issuers may repurchase their stock outside of the safe harbor, but will not then benefit from its protections. Without the protections of the safe harbor, the issuer carries the burden of

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34. See Purchases of Certain Equity Securities by Issuer and Others, 17 C.F.R. § 240.10b-18 (2003).
35. 17 C.F.R. § 240.10b-5. Rule 10b-5 prohibits individuals and entities from directly or indirectly using a facility of a national securities exchange: to employ any device, scheme or artifice to defraud, ... to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or ... to engage in any act, practice or course of business which operates or would operate as a fraud or deceit on any person, in connection with the purchase or sale of any security.
37. See 17 C.F.R. § 240.10b-18(b).
38. Id. Before the adoption of Rule 10b-18, the Commission proposed Rule 13e-2, a mandatory rule. Missy Piccioni, Note, A Regulatory Response by the Securities and Exchange Commission to the Terrorist Attacks on America—Did the Issuer Repurchase Relief Make a Difference?, 34 RUTGERS L.J. 565, 572-73 (2003). But pursuant to research that revealed the often legitimate motives and benefits to investors regarding issuer repurchases, the SEC abandoned the proposal for a mandatory rule in favor of a rule that made compliance voluntary. See id. Thus, not wishing to prevent legitimate issuer repurchase programs, the Commission created the safe harbor of Rule 10b-18. Lloyd H. Feller & Mary Chamberlin, Issuer Repurchases, REV. SEC. REG., Jan. 11, 1984, at 993-94. In addition to illustrating that the current rule is less restrictive than the proposed, but never enacted predecessor, this also demonstrates the initial policy that issuer repurchases should be allowed, and even encouraged, absent persuasive evidence that the issuer seeks to manipulate the market through repurchasing shares of its common stock. Id.
proving that its acts were both non-fraudulent and non-manipulative.

Only a "Rule 10b-18 purchase" is eligible for protection against charges of market manipulation provided by the rule's safe harbor. A Rule 10b-18 purchase "means a purchase of common stock of an issuer by or for the issuer or any affiliated purchaser of the issuer." There are several exceptions to the rule's safe harbor, the most notable being that a repurchase "pursuant to a merger, acquisition, or similar transaction involving a recapitalization" falls outside of the safe harbor.

In addition to satisfying the definition of a rule purchase, the transaction normally must meet the conditions regarding volume, price, timing, and manner imposed by the Rule. First, a repurchase must meet the broker-dealer conditions, which require all repurchases or bids to repurchase be made through the same broker or dealer during a single trading day. Second, the timing condition of Rule 10b-18 prohibits an issuer from performing "the opening trade on any given day and [the issuer] may not trade during the thirty minutes before the market closes." The rationale for preventing repurchases during the last half-hour of trading is a belief that this is the period when markets are most volatile. Third, the price for a repurchase or bid to repurchase cannot be above either the highest current

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40. § 240.10b-18(b).
41. § 240.10b-18(a)(3).
42. § 240.10b-18(a)(3)(iv) (emphasis added).
43. If the issuer is repurchasing its common stock in the form of a block purchase, the Old Rule excused compliance with the volume condition since the block purchases were not subject to the twenty-five percent volume limitation, and the block was excluded when calculating the security's ADTV (average daily trading volume). See § 240.10b-18(b)(4).
44. § 240.10b-18(b)(1) (2003).
45. See Purchases of Certain Equity Securities by the Issuer and Others, 17 C.F.R. § 240.10b-18(b)(1) (2003). "For purchasers to satisfy the 'safe harbor' they must satisfy the following conditions: (1) [One broker or dealer] effects all Rule 10b-18 purchases from or through only one broker on a single day, or if a broker is not used, with only one dealer on a single day...." Id.
46. § 240.10b-18(b)(2).
independent published bid or the last independent sale price. The preceding limitation finds support in the proposition that, generally, the share price rises after an issuer announces its intention to proceed with a buyback program. Thus, the price condition seeks to ensure "that the issuer [would not lead] the market for the security through its repurchases." Finally, the volume of repurchases, not including block purchases, could not exceed the higher of one round lot (100 shares) or twenty-five percent of the average daily trading volume of the stock (ADTV). Under Rule 10b-18, a block purchase is a quantity of stock that (i) has a purchase price of $200,000 or more; (ii) consists of 5,000 or more shares with a purchase price of at least $50,000; (iii) is at least twenty round lots of a security that totals at least 150% of the daily trading volume for that security; or (iv) is at least twenty round lots of the security and amounts to at least one-tenth of one percent of the security’s outstanding shares. The last condition excludes any shares owned by an affiliate, provided that the necessary trading volume statistics are not readily available. If the issuer repurchased its common stock in the form of a block purchase, the rule excused compliance with the volume condition.

48. See § 240.10b-18(b)(3).
49. See, e.g., David Ikenberry, et al., Market Underreaction to Open Market Share Repurchases, 39 J. FIN. ECON. 181, 190-91 (1995) (suggesting that a firm’s unexpected announcement of a repurchase program may be viewed as a positive shock to its stock price). An example of this positive shock phenomenon can be seen in the repurchasing activity that coincided with the opening of the stock markets after the September 11th terrorist attacks. See Anita Raghavan, Team Effort: Banks and Regulators Drew Together to Calm Markets After Attack, WALL ST. J., Oct. 18, 2001, at A1 (“After huge losses in the week after the terrorist attacks, several stock indexes stand just a shade below their Sept. 11 levels. . . . There are many reasons the market stabilized, ranging from companies’ stock buybacks to ordinary perception of value by investors.”).
51. See Purchases of Certain Equity Securities by the Issuer and Others, 17 C.F.R. § 240.10b-18(b)(4).
52. “The term round lot means 100 shares or other customary unit of trading for a security.” 17 C.F.R. § 240.10b-18(a)(13).
53. See § 240.10b-18(b)(4)(i). The average daily trading volume, hereinafter referred to as ADTV, is the daily average of the reported volume for the security in the four calendar weeks preceding the week that the rule purchase or bid is to be initiated. See Piccioni, supra note 38, at 572.
54. See § 240.10b-18(a)(14).
55. See id.
Block purchases were not subject to the twenty-five percent volume limitation and the block was excluded when calculating the security’s ADTV. The Commission included a cap on volume amid concerns that without such a limitation, an issuer could dominate “the market for its securities through substantial purchasing activity.”

III. THE PROPOSAL TO REVISE RULE 10B-18

In December 2002, the Commission released a proposal to revise Rule 10b-18 and, pursuant to the Commission’s policy, requested public comment on the proposed rule before final approval of the changes. The proposed modifications apply to the timing of the repurchases, as well as the volume and prices at which an issuer may repurchase its securities while still falling under the protective blanket of the rule’s safe harbor. The proposal engendered instantaneous outcries from financial institutions both large and small, financial holding companies, and made strange bedfellows of Wal-Mart and the banking industry. Such widespread and “principled opposition” to the proposal should have given the Commission cause for concern, and prompted an inquiry into the potentially irreversible and devastating impact such changes would visit upon the banking industry. Instead, the Commission approved an ill-conceived and patchwork regulatory regime, while failing to take note of the many objections or consider meaningful alternatives.

58. Id.
59. See id.
60. See Todd Davenport, Frequent Buyers Worried About SEC Proposal, AM. BANKER, Aug. 5 2003, at 7A.
61. Id.
A. The Block Exception Proposal

Rule 10b-18, under its original form, excludes those repurchases known as block purchases from the volume limitation that all other repurchases must meet in order to fall under the rule's safe harbor. Thus, an issuer may purchase a block of its own stock and still be protected by the Rule's safe harbor, though technically it is not complying with the volume requirement. In a departure from the current rule, and over twenty years of good faith reliance upon it, the Commission has eliminated the original block exception to Rule 10b-18.

The New Rule amends the volume limitation by including block purchases in the calculation of a security's ADTV and the concomitant twenty-five percent volume limitation. As an alternative to the twenty-five percent volume limitation, an issuer could choose to repurchase 500 shares of its common stock per day, if this amount is greater than the twenty-five percent restriction. Third, the amendment applies "alternative volume conditions (which are applicable only during the trading session immediately following a market-wide trading suspension), by increasing the 25% volume limitation to 100%." Finally, the New Rule permits an issuer to make one block purchase per week within the safe harbor, so long as the issuer does not conduct

62. See supra notes 22-41 and accompanying text. Generally, the block purchase comes in two forms. See Fried, supra note 10, at 422. First, the issuer will conduct the block purchase on the open market. See Piccioni, supra note 38, at 566. For instance, a purchase may be conducted to fund employee stock option plans or to effect the most optimal use of capital resources. See Ók-Rial Song, Hidden Social Costs of Open Market Share Repurchases, 27 J. CORP. L. 425, 427 (2002). Second, a "significant" number of repurchases are purchases that are "brought to [the issuer] on an unsolicited basis." See UMB Financial Corporation Comment to Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others; SEC Release No. 33-81600 (Feb. 18, 2003) [hereinafter UMB Financial Corporation] at http://www.sec.gov/rules/proposed/s75002/drrilinger1.htm (last visited Feb. 7, 2004).

63. See Purchases of Certain Equity Securities by the Issuer and Others, 17 C.F.R. § 240.10b-18(b)(4) (2003). In short, the block exception allows an issuer to purchase a block of its stock without complying with the volume limitation. Id.

64. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,959-64,960 (Nov. 7, 2003) (to be codified at 17 C.F.R. § 240.10b-18).

65. See id. at 64,959.

66. See id. at 64,959.

67. Id at 64,961.
another Rule 10b-18 purchase on the day of the block activity.\textsuperscript{68} Thus, the proposal significantly reduces the amount of stock an issuer can repurchase in a single day under the Rule 10b-18 safe harbor.

\textbf{B. Reasons for the Amendment}

According to the Commission, the current market conditions no longer justify excluding block purchases from the volume limitation.\textsuperscript{69} The Commission based this conclusion on the increased utilization of block purchases in the current markets, and the absence of a limitation on the number of block purchases that an issuer can make on a single trading day.\textsuperscript{70} Therefore, the proposal aims to alleviate the Commission’s concern that the block exception could allow issuers to dominate the market for their securities in a manner that the drafters of the safe harbor could not have foreseen.\textsuperscript{71}

According to the Rule, the initial justification for exclusion was that “the Commission viewed the market impact of block purchases as being less than that of a series of smaller purchases that, in the aggregate, are equal in size to a block but are accomplished over a period of time and so could give the impression to the market of multiple investment decisions to buy and more likely affect the market price.”\textsuperscript{72} Recently, the Commission’s concern has evolved into a fear that “investors will be misled about the integrity of the securities trading market as an independent pricing mechanism,”\textsuperscript{73} if issuers utilize the block exception to “dominate” the market for their securities. One should hesitate before faulting the Commission for attempting to restore investor confidence in the securities trading market. But the current proposal would mark a return to the very scenario that

\textsuperscript{68} Id. at 64,960.


\textsuperscript{70} See id. at 77,599-600.

\textsuperscript{71} See id. at 77,600.

\textsuperscript{72} Id. at 77,599.

\textsuperscript{73} Id.
the 1980 Commission sought to avoid in excluding the block purchase from the volume limitation of the safe harbor. Thus, the problem lies not in the Commission’s goal, but in its assumption that the securities trading market is an independent pricing mechanism, as well as in its failure to consider the reality that the block exception has proven beneficial to both issuers and the market.\textsuperscript{74}

In its proposal to amend the Rule, the Commission notes that issuers use the safe harbor, as well as the block exception, to manipulate the price of their securities.\textsuperscript{75} Aside from the Commission’s failure to cite any evidence of such manipulation, the Commission also errs in confusing an issuer’s illegal desire to boost the market price of its security with the necessary goal of avoiding a significant downward pressure on the share price. For instance, the block exception allows the issuer to provide liquidity for institutional investors.\textsuperscript{76} Without the block mechanism, the market might be unable to absorb such a large holding.\textsuperscript{77} Under the New Rule, an issuer would be unable to acquire such a block, and this inability “could put significant downward pressure on the price of the issuer’s stock.”\textsuperscript{78} According to this explanation, the block exception does not allow the issuer to raise the price of its stock, but “relieve[s] or neutralize[s] the downward pressure on the market price of its stock.”\textsuperscript{79} Thus, the risk of manipulation in


\textsuperscript{75} See, e.g., Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others, 67 Fed. Reg. 77,594, 77,600 (Dec. 18, 2002) (to be codified at 17 C.F.R. § 240.10b-18) (explaining that issuers have, during contested takeovers, purchased significant chunks of stock via the block exception, thereby reducing the spread between competing offers.) But one should note that the Commission prevents the aforementioned behavior by tightening the definition of a merger for purposes of the Rule, i.e., an issuer cannot repurchase its stock in any amount from the date of public announcement until the merger is finalized. See supra note 19 and accompanying text. If an issuer cannot conduct a repurchase program during the merger period, then the original block exception will not assist a circumvention of the Rule. Put another way, the elimination of the block exception is an unnecessary case of overreaching.

\textsuperscript{76} See Sullivan, supra note 74, at 8.

\textsuperscript{77} Id.

\textsuperscript{78} Id.

\textsuperscript{79} Id.
the absorption of the holdings of an institutional investor is, contrary to the Commission’s belief, relatively low. The ill-founded charge of using the block exception to manipulate share price proves to be nothing more than a mirage, and with that, a cornerstone of the Commission’s rationale falls to the wayside.

As some commentators have noted, federal securities laws provide only minimal regulation of share repurchases, unless undertaken as a counterattack to an unsolicited takeover bid. Rule 10b-18 provides only an optional safe harbor, thus, the rule still allows an issuer to repurchase as much of its stock as it wants. Nevertheless, the Commission should have hesitated before overhauling a rule on which issuers have relied for twenty years, absent compelling evidence that issuers have been accessing not only the Rule 10b-18 safe harbor, but the block exception, to manipulate the share price. On the other hand, if such evidence exists, the Commission should make a showing that its charges have a sound basis. In addition, one must distinguish between evidence of market manipulation pursuant to repurchases, and manipulation undertaken through the block exception. Evidence that an issuer is raising its share price does not necessarily mean that such manipulation occurs via the block exception. For instance, the issuer could be using the price, or broker-dealer limitation as a vehicle to exploit the market. In short, the Commission should not just make a showing of illegal activity, but produce evidence that the block exception is the loophole.

C. Effect of the Amendment on Small Financial Institutions

The Commission’s proposal to amend the Rule began by conceding that, “[i]ssuers repurchase their securities for many legitimate business reasons.” Among these “legitimate business

80. See Fried, supra note 10, at 423.
81. Id.
83. § 240.10b-18 (a)(2).
reasons” are repurchases to provide the shares necessary for “dividend reinvestment, stock option and employee stock ownership plans, or to reduce the outstanding capital stock following the cash sale of operating divisions or subsidiaries.”

To meet these legitimate goals, securities laws must allow issuers to access the market and absorb significant amounts of their common stock on a regular basis. The release fails to note, however, that the elimination of the block purchase exception adopted by the revised Rule 10b-18 would force issuers, particularly small banks and savings associations, to pursue these activities outside of the safe harbor, which, in practice, would halt repurchases. Such a drastic measure is unnecessary for financial institutions, because existing banking regulation limits the number of shares that a bank or savings association can issue to the amount released in the initial offering. Federal law precludes a savings association from issuing additional shares. As a result, savings associations are completely dependent upon repurchasing to meet the demands of their stock option and incentive programs. This dependency becomes all the more acute when one considers that the stock of such organizations is not widely traded. This chilling effect is due to the reality that issuers are reluctant, if not unwilling, to undertake any repurchases without the certainty that their purchases will come within the protective confines of the safe harbor. Moreover, the issuer is not the only party involved in the repurchase transaction who is nervous about the prospect of repurchasing outside the safe harbor. Even brokerage firms, on which the issuer relies to complete the transaction, are uncomfortable participating in such a transaction, even though they would not be held liable for any resulting manipulation.

85. Id.
87. Id.
88. Id.
89. See supra notes 89-106 and accompanying text.
90. Davenport, supra note 60, at 7A.
91. Id.
In adopting the proposal, the Commission neglected to consider the reality that the elimination of the block purchase exception will preclude a community bank or savings association from repurchasing its shares. The Commission also failed to address the adverse impact such a regulatory regime will have on repurchases, such as raising the transaction costs of non-block repurchases and diminishing the market demand for an institution’s stock.92

One reason an issuer may seek to repurchase shares of its common stock is to reduce outstanding capital and thereby increase its return to shareholders (ROE).93 This motivation is a particularly important tool for a bank adjusting to life as a publicly traded company.94 For instance, after OceanFirst Financial Corporation (OceanFirst) went public, its capital exceeded twenty percent of its assets.95 OceanFirst addressed this problem through a capital management program, the centerpiece of which was to repurchase outstanding shares of its common stock through the block purchase mechanism.96 Pursuant to this plan, OceanFirst repurchased 14 million shares of its common stock.97 During 2002, OceanFirst repurchased approximately 1.25 million shares exclusively through block purchases.98

Without the block exception, OceanFirst, and similarly situated financial institutions, would have been unable to reduce their capital levels to a manageable percentage via stock


95. Id.

96. Id.

97. See id. The block purchase exception to the volume limitation of Rule 10b-18 aided OceanFirst in reducing its capital level from 20% prior to the initiation of the repurchase program to a manageable 7.8% by the end of 2002. Id. Conversely, the program facilitated the change in the company’s return on equity from 6% on the eve of the repurchase plan to 14.3% upon the completion of the exercise. Id.

98. Id.
repurchases. On the day that the OceanFirst submitted its comment to the Commission's proposal, the ADTV of the company's stock was 8,000 shares, well beyond the 500 shares proposed by the SEC as an alternative to the ADTV. Under the New Rule, another small to moderate financial institution, UMB Financial Corporation (UMB), would only be able to purchase .06 percent of its shares that are included in the public float. OceanFirst purchased shares in blocks ranging in size from 10,000 to 50,000 shares or more, a typical range in these situations. Further, of the shares OceanFirst repurchased during 2002, seventy percent were effected in blocks of 10,000 or more.

Under the new regime, OceanFirst would have been able to conduct one of these block purchases per week, but at a cost of sacrificing any Rule 10b-18 purchases for the rest of that trading day.

One could argue that the 500 share alternative is a sufficient balance to counter the elimination of the block exception. But rarely will a bank's stock be so thinly-traded that the ADTV limitation will be less than 500 shares. Furthermore, although potentially attractive in theory, the 500 share ceiling is useless in practice because unsolicited blocks, the form that the majority of block purchases take, brought to an issuer from institutional investors will rarely be as small as 500 shares.

In addition to assisting a financial institution in maintaining healthy capital levels, the block exception also reduces the costs associated with repurchasing. The block purchase exception enables all issuers, regardless of their size and how actively their stock is traded, to receive preferable pricing by purchasing a large

99. Id.
100. See UMB Financial Corporation, supra note 62.
101. See OceanFirst, supra note 94.
102. Id.
103. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,960 (Nov. 17, 2003) (to be codified at 17 C.F.R. § 240.10b-18).
104. See OceanFirst, supra note 94.
105. See, e.g., UMB Financial Corporation, supra note 62 (explaining that the majority of block purchases are unsolicited bids brought to the issuer by institutional investors).
block of shares, thereby reducing overall transaction costs, including the commission.106

D. Elimination of the Block Exception Would Unduly Burden Small Financial Institutions

The block exception is particularly attractive to small and moderate-sized financial institutions, as well as institutional investors.107 As discussed in the preceding section, the block purchase exemption allows companies whose stock is not heavily traded to make significant purchases of their stock over a realistic timeframe.108 Without the benefit of the exception, these institutions will be forced to acquire small amounts of their stock over a prolonged period of time.109 This unwanted effect will likely increase market volatility, contrary to the Commission's stated goal.110

Besides promoting the financial goals of banks, the block exception also allows large investors to pursue their investment strategies.111 Generally, the institutional investor sells its holdings in a company in the form of a block purchase.112 Thus, the block purchase exception accommodates institutional transactions, alleviating the concern among large investors that an investment in a bank or savings association stock will present liquidity issues.113

106. See America's Community Bankers, supra note 86.
107. See, e.g., UMB Financial Corporation, supra note 62 (stating that the block exception allows UMB and companies of similar size "to administer an employee stock ownership plan, an employee stock purchase plan, and for other appropriate business purposes."). The UMB comment also notes that the block exception liquidity for shareholders with large holdings — i.e., the institutional investor. Id.
109. See id.
111. See e.g., NBT Bancorp, supra note 108 (noting that the elimination of the block exception "will scare off or keep away potential large investors who will fear that the issuer does not have enough liquidity or other institutional investors to allow for an orderly exit strategy out of its stock.").
112. See e.g., America's Community Bankers, supra note 86 (explaining that "block purchases accommodate large institutional transactions.").
113. See id.
If an institutional investor knows an issuer with a thinly traded stock cannot engage in block transactions because of volume limitations, the investor will probably not invest in the issuer's security. Therefore, the amendment will have a "very real, and potentially devastating, impact on the marketability of [a small] institution's stock," making it even more difficult for thinly traded companies to attract investors.

The potential traumatic effects of the Commission's amendment are not confined to the departure of institutional investors. One of the stated goals of the revision is to increase investor confidence in the stock markets. Thus, one would expect the amendment to eliminate the blanket of fog surrounding market activities. But the practical result of the proposed reforms will be to perpetuate investor uncertainty. From the investor's standpoint, recognition and assessment of the impact of numerous smaller purchases over time by an issuer will be more difficult than that of the fewer block purchases.

The problem with the amendment is not limited to the fact that it fatally disadvantages smaller banks and bank holding companies. More importantly, the revision subjects larger banks and bank holding companies, whose stock is traded at a higher level, to more favorable treatment. As noted above, a repeal of the block exception would prohibit a company whose stock is not heavily traded from making purchases of their own stock over a realistic time-frame. Fortunately, many large bank holding companies face a more certain future than their smaller counterparts since the amended rule includes block purchases.

114. Id.
115. Id.
117. Id.
118. While the repeal of the block exception bestows favorable treatment upon larger financial institutions (the larger the institution the more heavily traded the stock will be, resulting in a higher ADTV), the proposed amendment of the rule governing repurchases pursuant to a merger will impact merger-minded institutions with a greater force. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,955 n.34 (Nov. 17, 2003) (to be codified at 17 C.F.R. § 240.10b-18).
within the ADTV calculation and the twenty-five percent volume limitation. Due to the high volume at which many larger corporation's stock is traded, their ADTV will be higher as well. Thus, while the 500-share alternative might not assist a large issuer in repurchasing blocks of its common stock, the issuer will at least be able to make such purchases while remaining within its ADTV and not exceeding the twenty-five percent volume limitation, therefore finding itself within the protective confines of Rule 10b-18's safe harbor.

Finally, the Commission's elimination of the block exception is inconsistent with an earlier proposal by the Commission to relax repurchase limitations during times of severe market stress, such as the day after a suspension in trading. One reason the Commission proposed to raise the allowable volume to 100% of the ADTV the day after a suspension in trading is to provide stability during a time of acute market volatility. One can infer from this proposal that extensive repurchasing provides stability. Oddly, the Commission wishes to create instability by removing block purchases from the safe harbor for issuers whose stock is thinly-traded, only to cut all restrictions once the instability rises to the level of distress enumerated in other proposals. Therefore, additional regulation eventually gives way to a situation devoid of oversight and the manipulation that should result once the New Rule becomes effective.

E. Alternatives to the Amendment

The Commission could accomplish its desire to modernize Rule 10b-18 to correspond to current market conditions by bringing the definition of what constitutes a block purchase in line

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119. Id.

120. ADTV is the average daily trading volume of an issuer's stock over a four-week period. See Purchasers of Certain Securities by Issuer and Others, 17 C.F.R. § 240.10b-18(b)(4)(i) (2003). As a result, the greater the trading volume, the higher the ADTV. Id.

121. See Piccioni, supra note 38, at 583-85.

122. See id. at 581 (noting that by relaxing the requirements of Rule 10b-18, the Commission sought to "facilitate the 'reopening of fair and orderly equities markets'"").

123. See id., at 583-85.
with that of the New York Stock Exchange (NYSE). The NYSE and National Association of Securities Dealers (NASD) define a block as the purchase of a quantity of stock with a purchase price of $500,000 or more, or at least 10,000 shares of stock with a purchase price of at least $200,000, whichever is less. These thresholds are twice that of Rule 10b-18’s definition of a block purchase. The benefits of adopting the NYSE and NASD standards are substantial. First, the change would address the Commission’s concern that Rule 10b-18 reflect current market conditions. Second, and more importantly, the NYSE definition adequately balances the competing concerns in this area: “the need to foster market liquidity and flexibility without increasing the potential for abusive market practices above an acceptable level.”

Third, the increased threshold would provide small to medium issuers more room to comply with the unsolicited bids from institutional investors. The latter is the most important, for it would remedy both the possible liquidity concerns of the institutional investor and the potential hemorrhaging in the stock price that would result from such an investor being forced to divest his shares in piecemeal fashion across the market.

An alternative proposal would be to keep the existing definition of a block purchase intact, include block purchases within the ADTV calculation, but amend Rule 10b-18(b)(4) to


125. See Purchases of Certain Equity Securities by the Issuer and Others, 17 C.F.R. § 240.10b-18(b)(4) (2003). As noted above, under Rule 10b-18, a block purchase is a quantity of stock that (i) has a purchase price of $200,000 or more; (ii) consists of 5,000 or more shares with a purchase price of at least $50,000; (iii) is at least 20 round lots of a security that totals at least 150% of the daily trading volume for that security; or (iv) is at least 20 round lots of the security and totals at least .01% of the outstanding shares of the security. See § 240.10b-18(a)(14).

126. Sullivan, supra note 74.

127. If the threshold reflected the more permissible definition of the NYSE and NASD, issuer repurchases of a thinly-traded stock would fall within the Rule’s twenty-five percent volume limitation. As a result, the issuer could conduct the repurchase within the rule and without relying on the block exception.

128. See NBT Bancorp Corp., supra note 108.

129. See 17 C.F.R. § 240.10b-18(b)(4).
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exclude block purchases from the volume limitation. This proposal incorporates the simplicity inherent in the Commission’s amendment to the manner in which an issuer calculates the ADTV. The alternative also recognizes that there are critically important reasons to retain the exception—foremost among them is addressing the hardship that will be placed upon small and medium issuers and their shareholders if the block exception is eliminated.

The New Rule adopted by the Commission was the once-per-week block exception to the volume limitation of Rule 10b-18. In making such a concession, the Commission seems to recognize the obstacle created for small and medium issuers in the initial proposal. But the new exception does not alleviate the concerns this note raises. In a classic case of form over substance, the “exception” is meaningless for small to medium issuers who have come to rely on the block exception as a mechanism for pursuing legitimate business activities. In addition, investors who practice trading in block form will spurn the stock of small and medium issuers for the more heavily traded stock, which they can liquidate in block form under the new regime. As a result, if the Commission desires to treat all issuers equally, it should re-amend the new rule to set a mutually agreeable level where issuers whose stock is thinly-traded could continue to use the block exception. Such an alternative would not favor small companies over large because, as noted above, an issuer whose stock is traded at a high

130. See Skadden, supra note 124.
131. See supra notes 116-18.
132. See supra notes 116-18.
133. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64,952, 64,960 (Nov. 17, 2003) (to be codified at 17 C.F.R. § 240.10b-18.).
134. See id. at 64,959-60.
135. As noted above, the once-a-week block exception would allow an issuer to make a block purchase of its stock once a week, provided it does not make any other Rule-10b-18 purchases on the day it acquires the block. See Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. at 64,960. Issuers used the original block exception to conduct legitimate business activities, such as funding employee stock option plans, whenever such blocks became available. See UMB Financial Corporation, supra note 62. But since the issuer is unable to predict when the block will become available, it cannot pursue such legitimate and crucial business activities with a mere once-a-week block exception.
136. See NBT Bancorp., supra note 108.
level will be able to fit block purchases under the new volume limitation. Large companies still, due to their size, retain advantages over the issuer whose stock is traded at a comparatively low level, but at least in the eyes of federal securities laws they would be equal.

IV. CONCLUSION

In an era where corporate malfeasance has significantly undermined investors' confidence in the integrity of securities markets, the Commission should be applauded for acting to reverse such a dangerous tide. Although the Commission has selected the right time to act and the right rule, regrettably, it has selected the wrong method.

Since its adoption in 1982, the underlying principle of Rule 10b-18 has been that "issuer purchases are beneficial for companies, shareholders and investors generally and should be permitted to continue freely at all times subject only to compliance with the conditions of the Rule."137 Admittedly, this premise should not apply when confronted with persuasive evidence that repurchases made under the particular circumstances of the Rule cause substantial harm to investors.138 Nevertheless, the Commission has failed to provide evidence in support of such a change in policy. For instance, in the release of the proposed rule, the Commission's proposal fails to cite any evidence that the block exception has led to market manipulation in the twenty plus years since the safe harbor came into existence. The release does cite two studies that have concluded that block transactions can affect share prices.139 The proposition that such purchases can affect market prices does not amount to evidence of fraudulent behavior or market manipulation. Without the block exception, repurchases will be conducted over a longer period of time and in smaller amounts; but these transactions too have the potential to affect

137. Sullivan, supra note 74.
138. Id.
139. See Rule 10b-18 and Purchases of Certain Equity Securities by the Issuer and Others, 68 Fed. Reg. 64, 952, 64,959 n.78 (Nov. 17, 2003) (to be codified at 17 C.F.R. § 240.10b-18).
market price.\textsuperscript{140} Moreover, the current state of affairs is not one where issuers are free to repurchase without limitations and oversight. Therefore, the Commission should retain the existing regulatory framework, and reserve the punitive aspects of the proposal for a future where evidence of clear harm actually exists.

Perhaps the best proposal the Commission could consider is to leave the existing regulatory regime untouched. For over twenty years issuers have relied on the safe harbor and the block purchase exception. Forcing financial institutions to walk away from this reliance would jeopardize existing business plans and the very existence of the community bank and savings association.

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\footnotesize{\textsuperscript{140} See id.}