

not quoted or reported in the consolidated system, the issuer will need to look to the highest independent bid or the last independent transaction price, whichever is higher, that is displayed and disseminated on any national securities exchange or on any inter-dealer quotation system, as defined in Exchange Act Rule 15c2-11(e)(2),<sup>59</sup> that displays at least two independent priced quotations for the security.<sup>60</sup> For all other securities, the issuer will need to look to the highest independent bid obtained from three independent dealers.<sup>61</sup> The amendments simplify and update the Rule by replacing the outdated definitions and price provisions (that depended on whether the security is a "reported security," "exchange traded security," "Nasdaq security," or "other security," and whether the bid or purchase is effected on an exchange) with a uniform price condition (*i.e.*, a two-prong—"highest independent bid" or "last independent transaction price"—price test), which applies to *all* securities, regardless of where they are traded. All of the commenters supported the proposal to apply a uniform price condition that retains both the "highest independent bid" and the "last independent transaction price" alternatives.

#### 4. Passive Pricing Systems

In the Proposing Release, we also sought comment as to whether Rule 10b-18's price condition should apply where the issuer has no control, directly or indirectly, over the price at which a Rule 10b-18 purchase will be effected, for example, "passive" (independently-derived) pricing, such as the VWAP. Several commenters favored excepting VWAP transactions from the Rule's pricing condition. One commenter specifically urged the Commission to except VWAP transactions from the pricing condition because VWAP matches do not influence price or provide price discovery.<sup>62</sup>

After considering the comments, we believe that excepting VWAP transactions from the Rule's pricing condition is premature at this time. However, we will continue to consider the commenters' recommendations, as well as current market practices involving VWAP transactions, in considering whether any future changes to the Rule are appropriate.

#### 5. Riskless Principal Transactions

In the Proposing Release, we sought specific comment regarding the application of Rule 10b-18 to riskless principal transactions. Riskless principal transactions raise the issue of how to apply the safe harbor to the two "legs" of the transaction: the broker-dealer's purchase in the market for its own account; and the issuer's purchase of the shares from the broker-dealer. The issuer and the broker-dealer (buying on behalf of the issuer) may seek to claim the protection of the safe harbor for both legs of the transaction.

We believe that the safe harbor should apply to riskless principal trades that are analogous to agency trades effected on behalf of the issuer. Thus, the safe harbor should apply only to those riskless principal transactions where both legs are effected at the same price and only one leg is reported to the market (*e.g.*, transactions that would qualify for trade reporting under the NASD riskless principal trade-reporting rules, which require that only the first leg of the transaction be reported, and not the offsetting sale to the issuer), provided that this first leg of the transaction meets all the conditions of Rule 10b-18.<sup>63</sup> Accordingly, we have amended the "Rule 10b-18 purchase" definition to clarify that purchases *for the issuer* include riskless principal transactions.<sup>64</sup> Paragraph (a)(12) of the Rule defines "riskless principal transaction" as a transaction in which a broker or dealer, after having received an order from the issuer to buy its security, buys the security as principal and then sells the security (to the issuer) to satisfy the issuer's buy order.<sup>65</sup> Under this definition, the issuer's purchase must be effected at the same price per share at which the broker or dealer bought the shares to satisfy the issuer's buy order, exclusive of any explicitly disclosed markup or markdown,

commission equivalent, or other fee. Moreover, only the first leg of the transaction (*i.e.*, when the broker or dealer purchases the shares in the open market), rather than the second leg (*i.e.*, when the broker or dealer sells the shares to the issuer) is reported under the rules of a self-regulatory organization or under the Act.<sup>66</sup> In addition, for purposes of this definition, a broker or dealer must have written policies and procedures in place to assure that, at a minimum, the issuer's order was received prior to the offsetting transaction; the offsetting transaction is allocated to a riskless principal account or the issuer's account within 60 seconds of the execution; and the broker or dealer has supervisory systems in place to produce records that enable the broker or dealer to accurately and readily reconstruct, in a time-sequenced manner, all orders effected on a riskless principal basis.<sup>67</sup>

#### 6. Volume of Purchases

##### a. Treatment of "Block Purchases" Under the Current Rule

Under the current volume condition, an issuer's block purchases are not subject to the Rule's 25% volume limitation, nor are the shares purchased by the issuer in block transactions included when calculating a security's four week ADTV.<sup>68</sup> This means that, under the current Rule, an issuer can purchase an unlimited amount of its securities if purchased in block size.

##### b. Proposal To Eliminate the "Block Exception"

Under the proposed amendments, to qualify for the safe harbor, an issuer would have to include its block purchases in its 25% volume limitation. However, the issuer also could include its block purchases in calculating its

<sup>66</sup> *Id.*

<sup>67</sup> We believe that these conditions will allow for surveillance of these transactions by linking the definition to specific incoming orders and executions, and by requiring brokers and dealers to establish procedures for handling such transactions. Moreover, requiring that the orders be received prior to the offsetting transaction and the allocation of the offsetting transaction to the issuer's account within 60 seconds will help prevent issuers (and brokers or dealers) from taking advantage of the safe harbor by retroactively claiming that a non-riskless principal transaction was done on a riskless principal basis. The requirement that an offsetting transaction be allocated to either a riskless principal or customer account within 60 seconds is a condition that is consistent with previously stated Nasdaq policy regarding the handling of mixed capacity trades and compliance with the Manning Interpretation. See NASD Notice to Members 01-85, at Question 7 and Notice to Members 95-67, at Question 5.

<sup>68</sup> 17 CFR 240.10b-18(a)(14) and (b)(4). See also Section II.C.4, *supra*.

<sup>59</sup> 17 CFR 240.15c2-11(e)(2).

<sup>60</sup> Amended Rule 10b-18(b)(3)(ii).

<sup>61</sup> Amended Rule 10b-18(b)(3)(iii).

<sup>62</sup> See, *e.g.*, comment letters from Vie Financial Group (dated March 3, 2003 and June 26, 2003).

<sup>63</sup> See NASD Rules 4632(d)(3)(B), 4642(d)(3)(B), and 6620(d)(3)(B). Under the NASD's trade-reporting rules, for certain riskless principal trades, the broker-dealer reports only one leg of the transaction (*i.e.*, the first leg of the transaction when the broker-dealer purchases the shares in the open market, rather than the offsetting transaction to the issuer). In order to qualify for riskless principal trade reporting, the trades must be executed at the "same price" (exclusive of an explicitly disclosed markup or markdown, commission equivalent, or other fee). See also Securities Exchange Act Release No. 41208 (March 24, 1999), 64 FR 15386 (March 31, 1999), NASD Notice to Members 99-65 (March 1999) and NASD Notice to Members 00-79 (November 2000). See also Securities Exchange Act Release No. 44291 (May 18, 2001), 66 FR 27760; Securities Exchange Act Release No. 33743 (March 9, 1994), 59 FR 12767-01 (March 17, 1994); and Securities Exchange Act Release No. 45194 (December 17, 2001), 67 FR 6 (January 2, 2002).

<sup>64</sup> Amended Rule 10b-18(a)(13).

<sup>65</sup> Amended Rule 10b-18(a)(12).