SIMPSON THACHER MEMORANDUM

The SEC's New Large Trader Reporting Rule

November 3, 2011

SUMMARY

With its recent adoption of Rule 13h-1 (the "Rule") and Form 13H pursuant to Section 13(h) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[1] the Securities and Exchange Commission (the "SEC") has established new requirements for large traders and the registered broker-dealers through which they trade. The Rule was adopted pursuant to the Market Reform Act of 1990.

The large trader reporting requirements have been adopted to assist the SEC in identifying, and obtaining trading information about, market participants that conduct substantial trading activity in the U.S. securities markets. The recent volatility in the financial markets, particularly the "flash crash" of May 6, 2010, and the increasing role of high frequency traders, who have been estimated to account for 50% or higher of total trading volume,[2] have highlighted the importance of large trader transaction data that might be necessary to reconstruct market events.[3]

The Rule requires that each market participant meeting the definition of a "large trader" file a Form 13H with the SEC through its electronic filing system, EDGAR. The information disclosed in the Form 13H will not be publicly available. Upon receipt of the Form 13H, the SEC will assign the large trader a Large Trader Identification Number ("LTID"), which the large trader must provide to each registered broker-dealer through which the large trader effects securities transactions and specify the account numbers with each such broker-dealer to which the LTID applies. Each broker-dealer must thereafter perform certain recordkeeping, reporting and monitoring functions.

To comply with the Rule, market participants must monitor their daily and monthly trading levels starting on the Rule's effective date, October 3, 2011, to determine whether they meet the definition of a large trader. The compliance date for large traders to begin making Form 13H filings with the SEC is December 1, 2011. The compliance date for registered broker-dealers to begin fulfilling their obligations under the Rule is April 30, 2012.

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[1] See SEC Release No. 34-64976 (July 27, 2011), 76 Fed. Reg. 149 (August 3, 2011) (the "Release").

[2] See the Release at Note 8.

[3] The SEC has pending a separate proposal that would establish a consolidated audit trail requirement for all transactions in NMS securities (as defined in footnote 4 of this Memorandum). This requirement would capture much more information than the Rule, but, if adopted, it would entail significantly more complexity and require a longer time frame to implement. See SEC Release No. 34-62174 (May 26, 2010), 75 Fed. Reg. 32556 (June 8, 2010).

A. LARGE TRADER DEFINITION

Under the Rule, a large trader is any person who:

- "directly or indirectly, including through other persons controlled by such person, exercises investment discretion over one or more accounts and effects transactions for the purchase or sale of any NMS security[4] for or on behalf of such accounts, by or through one or more registered broker-dealers, in an aggregate amount equal to or greater than the "identifying activity level," namely two million shares or $20 million in any calendar day, or twenty million shares or $200 million in any calendar month; or
- voluntarily registers as a large trader by electronically filing a Form 13H with the SEC.[5]

1. Calculation of the Identifying Activity Level

For the purpose of calculating whether a trader meets or exceeds the identifying activity level of aggregate transactions in NMS securities equal to or exceeding two million shares or $20 million in any calendar day, or twenty million shares or $200 million in any calendar month, both purchase and sale transactions are included and are not offset against each other. The Rule also prohibits the netting or offsetting of transactions among or within accounts. With respect to listed options, the volume and value of the options purchased or sold count for purposes of the identifying activity level. Such identifying activity level with respect to listed options is determined by reference to the securities underlying the options. For example, 50,000 XYZ shares and 500 XYZ listed call options constitute aggregate transactions of 100,000 XYZ shares (i.e., 50,000 + 500 options x 100 shares per option = 100,000).[6]

The Release notes that the large trader definition may capture entities that trade infrequently but in transactions of sufficient magnitude to meet the identifying activity level. Such entities may be eligible for Inactive Status, as discussed below. A trader that is uncertain whether it will reach the identifying activity level and wishes to avoid the burden of monitoring transactions in NMS securities to determine when the identifying activity level is reached may voluntarily register as a large trader by filing a Form 13H with the SEC.

2. Exempt Transactions

For the purpose of determining whether a person is a large trader, purchases or sales of NMS securities pursuant to exercises or assignments of option contracts are excluded from the definition of "transaction." The following transactions are also excluded from the definition of

[4] An NMS security is defined as "any security or class of securities for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan, or an effective national market system plan for reporting transactions in listed options." This generally includes U.S. exchange-listed securities, including common stock, convertible preferred stock and options but excluding non-convertible preferred stock and fixed income instruments.

[5] See Rule 13h-1(a)(1).

[6] See the Release at Note 64.

transaction for the purpose of determining whether the identifying activity level has been reached because the SEC has determined that they are not effected with an intent that is commonly associated with arm's-length trading of securities in the secondary market:

- journal or bookkeeping entries to record the receipt or delivery of securities pursuant to the settlement of a transaction;
- transactions that are part of a registered or unregistered offering by an issuer or by an underwriter on behalf of an issuer, other than an offering effected through a national securities exchange;
- gifts;
- transactions by fiduciaries pursuant to the distribution of a decedent's estate;
- transactions effected pursuant to a court order or judgment;
- transactions effected pursuant to a rollover of tax-qualified plans;
- transactions between an employer and employee pursuant to an issuer benefits plan or compensatory arrangement; and
- transactions to effect a business combination, issuer tender offer, stock buyback by an issuer, stock loan or equity repurchase agreement.

Notably, sales by entities other than the issuer in secondary offerings are not excluded from the definition of transaction. Accordingly, a selling stockholder who sells a block of securities in a secondary offering in an amount equal to or exceeding the identifying activity level will qualify as a large trader even if its sole trading activity is its participation in the secondary offering.

3. Investment Discretion

For the purpose of determining whether a person has "investment discretion," the Rule embraces the definition of "investment discretion" in Section 3(a)(35) of the Exchange Act, which includes within the meaning of "investment discretion" the authority to determine what securities are to be purchased or sold, as well as the actual making of investment decisions regardless of whether another person may have responsibility for such decisions. The Rule specifies that an employee who exercises investment discretion within the scope of employment is presumed to do so on behalf of the employer. Accordingly, to the extent that an employee individually or collectively with others satisfies the large trader definition, the employer would be a large trader under the Rule.

4. Control

The Rule defines "control" as the "possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of securities, by contract, or otherwise." Furthermore, a presumption of control arises when a person "directly or indirectly has the right to vote or direct the vote of 25% or more of a class of voting securities of an entity or has the power to sell or direct the sale of 25% or more of a class of voting securities of such entity, or in the case of a partnership, has the right to receive, upon dissolution, or has contributed, 25% or more of the capital."[7]

5. **Parent Company Registration**

The Release states that the large trader definition is designed to focus on the ultimate parent company of an entity or entities that employ or otherwise control the individuals that exercise investment discretion. Parent companies must account for the aggregate trading activity of all of their controlled entities and may satisfy the requirements of the Rule on behalf of those controlled entities. By focusing the filing requirement on controlling entities, the SEC is able to gather information about primary institutions that conduct substantial trading operations while reducing the compliance burdens of the Rule. The Rule also permits compliance by controlled entities on behalf of a parent company as long as such entities comply with the Rule with respect to all of the accounts over which the parent company and its controlled entities directly or indirectly exercise investment discretion.

Although reporting is permitted at the parent company level, Form 13H allows a large trader to assign LTID suffixes to sub-identify persons, divisions, groups and entities under its control. Use of LTID suffixes may facilitate a large trader's ability to track trading activities with particularity and to more efficiently respond to any SEC request to further identify accounts or disaggregate trading data. LTID suffixes have three characters, all of which must be numbers. The SEC encourages large traders to use LTID suffixes.

B. TYPES OF FORM 13H FILINGS

Form 13H contemplates six types of filings:

- **Initial Filing**: A large trader is required to submit an Initial Filing "promptly" (within ten days) after it effects transactions that reach the identifying activity level. No Initial Filings will be required to be submitted prior to December 1, 2011.
- **Annual Filing**: A large trader must submit an Annual Filing within 45 days after the end of each full calendar year unless it is on Inactive Status, as discussed below.
- **Amended Filing**: If any information in a filing becomes inaccurate for any reason, an Amended Filing must be submitted promptly (within ten days) following the end of the calendar quarter in which any of the information contained in the Form 13H becomes inaccurate unless the large trader is on Inactive Status. A large trader may voluntarily file Amended Filings more frequently than quarterly.
- **Inactive Status**: A large trader may submit a Form 13H to obtain Inactive Status if its aggregate transactions have not reached the identifying activity level during the previous full calendar year. Inactive Status is effective upon the submission of such a filing. A large trader on Inactive Status is exempt from Annual and Amended Filing obligations and may request that its broker-dealers cease maintaining records of its transactions by LTID. Inactive Status is designed to reduce the burdens of the Rule on

[7] See Rule 13h-1(a)(3).

infrequent traders who may reach the indentifying activity level on rare occasions but do not regularly engage in transactions of sufficient magnitude to justify continued large trader status.

- **Reactivated Status**: If an entity on Inactive Status again reaches the identifying activity level, it must promptly file a Form 13H to report Reactivated Status and inform its broker-dealers of the change in status.
- **Termination Filing**: An entity that has ceased operations may elect to terminate its status as a large trader by submitting a Termination Filing.

C. DISCLOSURE REQUIRED IN FORM 13H

Form 13H contains the following six items to be completed by a large trader to allow the SEC to understand the character and operations of the large trader:

- **Item 1**: **Businesses of the Large Trader.** The large trader must indicate the businesses engaged in by it and its Securities Affiliates[8] and provide a description of the nature of its operations and those of its Securities Affiliates, including a general description of the trading strategies for each such entity.
- **Item 2**: **Securities and Exchange Commission Filings.** The large trader must indicate whether it or its Securities Affiliates file any other forms with the SEC. If so, this item requires identification of each filing entity, the form(s) filed by that entity and the applicable CIK number.
- **Item 3**: **CFTC Registration and Foreign Regulators.** The large trader must disclose whether it or its affiliates[9] are registered with the Commodity Futures Trading Commission (the "CFTC") and whether it or its Securities Affiliates are regulated by a foreign regulator. If so, it must identify each entity and the CFTC registration number or primary foreign regulator, as applicable.
- **Item 4**: **Organization Information.** The large trader must provide an organizational chart that identifies the large trader, its parent company (if applicable), all of its Securities Affiliates and all entities identified in Item 3 as being registered with the CFTC. For Securities Affiliates and entities identified in Item 3 as being registered with the CFTC, the large trader must provide a Market Participant Identification Number ("MPID") if the entity has one, a description of the entity's business and a description of the relationship of the entity to the large trader. If any entities within the large trader file separately, the large trader must provide their LTIDs and LTID suffixes, if any. The large trader must also identify any affiliates that have been assigned LTID suffixes and must provide those suffixes.

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[8] Securities Affiliate means an affiliate of the large trader that exercises investment discretion over NMS securities.

[9] Affiliate means any person that directly or indirectly controls, is under common control with or is controlled by the large trader.

- **Item 5**: **Governance of the Large Trader.** The large trader must specify whether it is a corporation, partnership, limited partnership, limited liability company or other form of entity and the jurisdiction in which it is organized. Each partner in a large trader general partnership and each limited partner in a large trader limited partnership that owns more than a 10% financial interest in the accounts of the limited partnership must be identified. Each executive officer and director of a large trader corporation and trustee of a large trader trust must be identified.
- **Item 6**: **List of Broker-Dealers at which the Large Trader or its Securities Affiliates have an Account.** The large trader must identify each U.S.-registered broker-dealer at which it or its Securities Affiliates have an account and specify the types of services provided (e.g., prime broker, executing broker or clearing broker).

The information provided by a large trader in Form 13H is treated as confidential in a manner consistent with the Exchange Act. However, the SEC indicates in the Release that the information contained in Form 13H filings may be disclosed to Congress, to other governmental agencies or pursuant to court orders.

D. BROKER-DEALER OBLIGATIONS

As noted above, after filing a Form 13H with the SEC through EDGAR, a large trader must identify itself and provide its SEC-assigned LTID to each U.S.-registered broker-dealer through which it trades and specify each account number to which the LTID applies.

A registered broker-dealer must maintain records of all transactions effected directly or indirectly by or through (1) an account the broker-dealer carries for a large trader or Unidentified Large Trader, which is a person that has not complied with the large trader identification requirements and that a registered broker-dealer knows or has a reason to know is a large trader, or (2) if the broker-dealer is itself a large trader, any proprietary or other account over which the broker-dealer exercises investment discretion.

The records must include substantially the same information that is already collected pursuant to the Electronic Blue Sheets (EBS) system but must include two additional data fields: the LTID (except in the case of Unidentified Large Traders) and the execution time of the transaction. For an Unidentified Large Trader, a broker-dealer must also maintain a record of the trader's name, address, date the account was opened and tax identification number. These records are required to be available on the morning after the day the transactions were effected (including Saturdays and holidays) and must be submitted to the SEC upon request through the EBS infrastructure. In unusual circumstances, the SEC may require records to be available on the same day the transactions were effected.

A registered broker-dealer must monitor transactions by Unidentified Large Traders but is not required to stop doing business with such entities. The Rule requires a registered broker-dealer to treat as an Unidentified Large Trader any person that the broker-dealer knows or has reason to know is a large trader if that person has not complied with the large trader identification requirements. In determining whether it knows or has reason to know whether a person is a large trader, the broker-dealer is only required to consider transactions in NMS securities that are effected by or through that broker-dealer on behalf of the person and is not required to seek additional information from its customers or from other broker-dealers.

There are two ways that a broker-dealer may conclude that it does not have reason to know that a person is a large trader. First, based on its knowledge of the nature of its customers and their trading activity, the broker-dealer may conclude that it has no reason to expect that a particular customer's transactions will exceed the identifying activity level. Second, the broker-dealer may be eligible for a safe harbor if it (1) has no actual knowledge that a person is a large trader and (2) establishes procedures designed to identify persons whose transactions at the broker-dealer equal or exceed the identifying activity level and, if they do, treat such persons as Unidentified Large Traders and notify them of their potential obligations under the Rule.

The obligations under the Rule apply only to U.S.-registered broker-dealers. The compliance date for registered broker-dealers to maintain records, report and monitor large trader activity is April 30, 2012.

E. FOREIGN LARGE TRADERS

Foreign large traders that execute transactions in NMS securities are subject to the Rule, and U.S.-registered broker-dealers for such foreign large traders must maintain and report the information required by the Rule. Furthermore, such registered broker-dealers must treat foreign intermediaries as any other clients for purposes of complying with the Rule.

F. IMPLICATIONS FOR PRIVATE EQUITY FUNDS

Private equity funds may fall within the large trader definition under certain circumstances. For example, a block trade or registered secondary offering of publicly traded securities after an initial public offering of a portfolio company could exceed the identifying activity level. The private equity fund must then identify itself to the SEC as a large trader. Filing obligations may also arise if a private equity fund controls (see definition above) a portfolio company that is a large trader. In this case, there are three registration options: (1) only the private equity fund registers; (2) the private equity fund and the portfolio company register separately; or (3) if the private equity fund and entities it controls do not directly or indirectly exercise investment discretion over any other accounts in which NMS securities are traded, only the portfolio company registers.

ACTION ITEMS

A. POTENTIAL LARGE TRADERS

- Determine whether you fall within the large trader definition.
- If you do not currently qualify as a large trader but might in the future, establish mechanisms to monitor trading in NMS securities in relation to the identifying activity level (keeping in mind that a single transaction can trigger a Form 13H filing requirement) or consider voluntarily filing a Form 13H.

- Compile the necessary information to complete Form 13H.
- Determine at what level(s) in your organizational structure to report and decide whether to use LTID suffixes.
- Prepare for notifications to registered broker-dealers once LTIDs are assigned.
- Establish mechanisms to monitor when Form 13H information becomes inaccurate and an Amended Filing is required and to compile updated information necessary to complete Annual Filings.
- Educate and train compliance personnel regarding the Rule.

B. REGISTERED BROKER-DEALERS

- Determine whether you fall within the large trader definition based on activity in your proprietary accounts (if so, see Action Items for Potential Large Traders above) and whether you carry accounts for entities that are large traders.
- Adopt policies and procedures to detect Unidentified Large Traders.
- Consider whether to modify your customer agreement and obtain representations from customers regarding large trader status.
- Establish a mechanism for linking LTIDs to customer accounts and develop data capture systems to comply with the recordkeeping, reporting and monitoring requirements of the Rule. These technology upgrades may require significant lead time to implement and test.
- Educate and train compliance personnel regarding the Rule.

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